FINANCIAL INSTITUTIONS COMMITTEE
Business Law Section, State Bar of California

Minutes of the Meeting of February 13, 2007

Committee Members Present:
Rosie Oda, Chair
Meg Troughton, Vice Chair
Bruce Belton, Secretary
Michael Abraham
Laura Dorman
Andrew Druch
Bart Dzivi
Andy Erskine
Ted Kitada
Elaine Lindenmayer
Teryl Murabayashi
Todd Okun
Richard de la Pena
Joseph Sanchez
Brad Seiling
Will Stern
Robert Stumpf
Shirley Thompson
Keith Ungles
Mike Zandpour

Advisory Members and Others Present:
Steve Balian
Sally Brown
Clay Coon
Mike Kimball
Bill Kroener
Mark Moore
Michael Occhiolini
Isabelle Ord
Mary Price
Jim Rockett
Kenneth Scott
Gerry Tsai
Chuck Washburn
Maureen Young

Committee Members Absent:
Linda Iannone
Kenneth Krown

Call to Order: Committee Chair Rosie Oda of Pillsbury Winthrop Shaw Pittman LLP called the meeting to order at 9:30 a.m.

1. Roll Call and Introductions: Rosie welcomed the Committee Members and the Advisory Members and asked each person to identify themselves and where they worked.

2. Approval of December 2006 Minutes: The Committee approved the minutes of the January 9, 2007 meeting.

3. Report on June 7, 2007 presentation by Sarah Kelsey, General Counsel of FDIC. Rosie Oda reported that Sarah Kelsey cannot meet with us on June 7 due to scheduling conflicts. A new date has not yet been selected.

4. FDIC Deposit Insurance Reform Rules. Bill Kroener of Sullivan & Cromwell LLP reported on the FDIC Deposit Insurance Reform Rules, as follows. A new Deposit Insurance Assessment System became effective January 1, 2007. Banks should be describing this system in their SEC 10-K filings. The preceding system had not been amended in ten years. Bill addressed the details of the system, assessment credits for existing deposit insurance covered institutions, and the temporary exemption for new institutions. There were also some clean-up mechanical changes that the FDIC wanted to implement.

Rules were promulgated under the Deposit Reform Act of 2005, which was enacted in 2006, together with a technical corrections bill enacted a week later. There have been no significant changes since 1996. FIRREA was to establish a risk-based assessment premium system. By the time it was implemented, it was not very risk differentiated. As a result of the 1996 legislation, most banks paid no deposit insurance premiums for the past ten years. Banks that were undercapitalized or supervised, paid premiums accounted for 4 to 6% of the industry. The former Bank Insurance Fund and Savings Association Insurance Funds were merged into the Deposit Insurance Fund as of March 31, 2006. Some larger institutions had both types of deposits and were able to arbitrage into the lower premium deposits. The resulting fund has a combined reserve ratio of 1.25% (the designated reserve ratio) and a single premium system.

The legislation was held up in various debates, one of which was how to address credit for past contributions. Since most Banks starting in 1996 did not pay premiums, those Banks that did pay were supporting the operations of the insurance fund program. Another issue was the “fast growth problem” arising from premiums calculated on the size of deposits compared to the size of the fund resulting in imposition of premiums against all banks due to increase in insured deposits.

The FDIC moved to a new more complex system, including an assessment credit for past contributions (paid prior to 1996) and temporary treatment for new institutions. Ultimately all Banks will pay something, which is different from the last decade where 95% paid nothing. This is a two-tiered based system based on size: $10 billion and above; and all others. There are now fewer categories of institutions. Risk category 1 is still 95% for large institutions. Half the assessment credit are long term issuer ratings, debt issuer ratings of the bank. Absent a debt issuer rating, it defaults to the small institution test based on financial ratios and weighted multipliers. The ratios taken into account are the Tier-1 leverage ratio, past-due loans compared to gross assets, non-conforming to gross assets, pre-tax income to weighted risk assets. Ratios for small institutions are based on CAMEL Ratings, also with weighted multipliers. Pricing multipliers are then applied to these ratios, and the sum of all products are added to, or subtracted from a uniform amount to determine the premium. Computations are set out in a federal register publication.

For the larger banks there will be additional adjustments. The FDIC retains the discretion to vary the assessment up or down by half a basis point in consultation with the institution's primary regulator. The FDIC adopted a set of base rates from 2 to 4 basis points per $100 of insured deposits. Under the rules the rates can be amended up or down 5 basis points without a new comment period. Rates adopted for 2007 and forward were between 5 and 7. Those can range up to 43 basis points for a 5 rated institution or one that is on the verge of failure.

Assessment credit for institutions that had paid-in prior to 1996 but since sold off some or all of their deposits, or for those that purchased deposits that were subject to premium payments, were resolved by allowing the transferor to keep the credit unless all or substantially all of the deposits were sold, i.e., 90% or more, in which case the credit belongs to the transferee. A temporary treatment was allowed for new institutions and going forward are treated in the highest category of risk-level 1 but grandfathered in for risk level 3 until January 2010 when the rules become applicable to new institutions.

The FDIC also adopted a designated reserve ratio which has historically been 1.25% of insured deposits. The 1996 Act adopted the same rate. Going forward the ratio can fluctuate which will affect the premiums charged to insured institutions. Also a dividend rule was adopted when the ratio is above 1.35%. Other issues were also cleaned up, e.g.,: (a) timing of assessments is now quarterly; (b) ratings changes are made effective immediately after exam results are known; and (c) assessment base changes to average daily balance and eliminate the float deduction.

Slides from the PowerPoint presentation are attached hereto.

5. IOLTA Proposal. Meg Troughton of Bank of America reported on the proposed amendments to the Business and Professions Code relating to attorney-client trust accounts as follows:

1. The California State Bar has circulated proposed bill language to amend the Business and Professions Code respecting Interest on Lawyer Trust Accounts (IOLTA accounts).

2. The idea behind IOLTA accounts was to have the Bar Association receive interest on small dollar amount receipts held by attorneys on behalf of their clients for short terms. For any individual client receipts, the combination of amount and term would not be great enough to earn any interest, but when aggregated by a lawyer or law firm would, overall, be interest bearing. The interest is used by the Bar Association to fund legal services to "qualified legal service projects" or "qualified support centers." This is administered by the Legal Services Trust Fund Program." IOLTA accounts are special operationally in that the lawyer opens the account in trust for whatever client(s) funds may be deposited. The lawyer receives the usual account statements plus notice of the amount paid to the Bar. The Bar Association also receives some account information and the interest earned, less reasonable fees.

3. Attached hereto is a redline of the Bar proposal compared to the current law.

4. Some of the big picture differences:

(a) Current law: the IOLTA account has to be an “interest bearing demand trust account.” Proposal: IOLTA becomes the name of whatever instrument is used by attorneys for its compliance with the Business and Professions Code requirements. IOLTA can be interest checking or investment sweep account or other product authorized by California Supreme Court rule or order. Also note there is a non-standard definition of what is acceptable “collateralization by government securities”.

(b) Proposal: A new concept of “comparable” account meaning an account paying interest or dividends by eligible institution not less than that paid to any non-IOLTA account of same type.
The proposal misses the point that there is no comparable account when you consider the essential IOLTA features: notice of account activity to holder (attorney); second notice of account activity to the State Bar; and payment of interest to the State Bar.

(c) Proposal: while we hear from one of the members of the Legal Services Trust Fund that there was no intent to require any action or account determination the banks, proposed Section 6212(b) uses the following language: “an eligible institution may consider . . . factors customarily considered by the eligible institution when setting the interest rate or dividends for its non-IOLTA customers, provided that such factors do not discriminate between IOLTA accounts and non-IOLTA accounts and that these factors do not include the fact that the account is an IOLTA account. The eligible institution shall calculate interest and dividends in accordance with its standard practice for non-IOLTA customers.

(d) Current Law: “reasonable fees” are deducted from the interest otherwise payable to the State Bar. (B & P 6212(c)(1))
Proposal: only defined “allowable reasonable fees” may be deducted from interest/dividends payable to the State Bar. “Allowable reasonable fees” as defined do not include some fees currently, regularly charged for the expanded new eligible accounts.

(e) Proposal: fees outside “allowable reasonable fees” may be charged, just not against the funds paid to the State Bar. They are the sole responsibility of the lawyer or law firm maintaining the account.

(f) Proposal: additional reports by banks to the Bar will be required. (For example, copies of overdraft notices must be sent to both the attorneys and the Bar.)

5. Substantially similar changes have been adopted in a less formal way in other states: e.g. Connecticut, Florida, South Carolina. None have been in effect for more than a few months.

6. One consulting company has worked with the various states to push through changes. It would be interesting to know how they are being paid.

7. Next step is for Meg to talk to Heather Irwin, attorney with General Counsel’s Office of the Bar. Meg will ask Heather for background information and volunteer the specific concerns outlined above, if appropriate.

8. On an on-going basis, the following Members and Advisors will be more closely involved: Keith Ungles, Ted Kitada, and Teryl Murabayashi.

Mark Moore commented that the Bill does not yet have a sponsoring legislator. He also reported that the Bar is usually involved in legislative issues for non-controversial issues that may require certain technical expertise. The current bill has moved more quickly through the process than is typical.

A motion was made and passed to delegate to Meg Troughton authority to make contact with the Bar regarding the proposal and any potential concerns that may impact financial institutions. Meg also requested that Ted Kitada and Keith Ungles assist her.

A redline copy of the proposed amendments to the law are attached hereto.

6. Interagency Guidance on Non-Traditional Mortgages. Andy Erskine reported on the Interagency Guidance on Nontraditional Mortgage Product Risks, as follows. The final guidance addressed three general areas: (a) long-term underwriting; (b) portfolio management; and (c) consumer disclosures. Underwriting was the area most commented upon. The guidance requires so-called “shopping” disclosures; servicing disclosures (e.g., negative amortization features); and notices to consumers where negative amortization triggers have taken place. Most lenders believe that their existing portfolio management practices are already in compliance. With respect to underwriting, the concern is that all non-traditional mortgage products need to be underwritten including an evaluation of the borrower’s ability to repay the debt by final maturity at the fully indexed rate and assuming a fully amortizing repayment schedule. Where there is a possibility of negative amortization, all of those products need to have a repayment analysis based on the initial amount plus any amounts that may be added to the balance based on the negative amortization.

Prior to the guidance, interest only loans were typically qualified based on the fully indexed rate (rather than the initial rate), but not an amortized rate. These were typically “affordability” loans with lower initial payments. Payment option ARMs were qualified based on 100% of the principal amount, but not the increased principal amount that could result from negative amortization. The Industry is generally taking steps to comply with the Guidance.

One issue raised was that the Guidance would only apply to banks and lenders that have some connection to a bank. The American Association of State Mortgage Regulators and others adopted a form of guidance nearly verbatim to the IAG for application to non-covered institutions, which has thus far been adopted by 23 states. California is not among those, and probably will adopt its own legislation or regulation in this area, and may include rules related to predatory lending. There are open questions whether state mortgage regulators have authority to enforce certain portions of the guidance, e.g., underwriting standards and risk management; areas that are more safety and soundness oriented versus consumer protection enforcement. Some states have simply adopted the guidance without any comment period, while others have adopted the guidance as only “best practices” versus minimum standards.

It may be that the level playing field concern is not a significant problem because the Guidance may ultimately be applicable to secondary market transactions. Hearings at the Senate Banking Committee appeared to encourage legislation in this area, and few Industry representatives raised opposition to the proposal. There was a focus on hybrid-ARMs (those were the interest rate initially fixed, becomes adjustable), and whether these should be defined as non-traditional mortgage products.

There are remaining questions on whether there will be legislation on a state and federal level. This seems likely, and perhaps adoption of “suitability” standards (e.g., as used in the securities industry). In conclusion, a majority of the mortgage market will be covered by some form of guidance, either federal or state. How such guidance is interpreted may vary substantially between federal and state agencies.

A copy of the Interagency Guidance is attached hereto.

7. Omitted.

8. Climate Change Affecting the Financial Services Industry. Teryl Murabayashi reported as follows: Attached is an article entitled “Climate Change Strategies for the Financial Services Industry.” Climate change is at or near a tipping point for public opinion change. A recent article in the New York Times reported significant awareness of climate change issues in Asia and Europe, but suggested that only a small percentage of US companies (e.g., 18% of CEOs said the were considering these issues or concerned about them). Some larger institutions have been addressing these issues within their own corporate governance and resource strategies, e.g., Bank of America and Wachovia. Financial Institutions and law firms can analyze their own greenhouse gas emissions from the standpoint of energy efficiency e.g., their buildings, lighting, new construction and local procurement versus shipped items. Small steps like using disposable water bottles and washable dishes in the company cafeteria should be considered. Public transportation should be encouraged for employees. Public awareness and company evaluation on these issues will effect corporate reputation and thereby impact its business. With respect to credit underwriting, borrowers should be analyzed for their impact and how the borrower’s industry is perceived and effected by these issues, e.g., auto industry compliance with the Clean Air Act. Climate change can impact agriculture and underwriting, e.g., last year’s freeze. Future regulations are unknown and what impact those will have on customers, including increased compliance expense. New opportunities can also present themselves by considering lending to “green” businesses and startups related to green industry. Law firms will also have opportunities in these areas by providing advice to clients engaging in green industries. These are the most important issues we face because of potential impact at all levels. Rosie mentioned that she is on the Board of New Resource Bank, the first “green” bank in the country focused on lending to sustainable energy producers and farmers. Many startups in this industry are not creditworthy and that issue should be addressed, whether through CRA credits or otherwise, to encourage growth and expansion. Pillsbury has its own special group on climate change and other firms are doing the same.

9. Recent FinCEN Report on Cross-Border Data Transfer. Maureen Young of Bingham McCutchen reported on cross-border data transfer as follows: FinCen reported to Congress on the feasibility of creating a wire transfer or funds transfers cross-border reporting system. Although the FinCEN report is now recommending that a cross-border transfer reporting system be adopted, it suggests proceeding incrementally. Prior to 9/11, under the BSA, reporting was required for wire transfers of $3,000 and over. After the USA Patriot Act, the reporting rule was not changed, but institutions needed to also focus on whether their funds transfer reporting was tied in with their BSA software to produce results that would be useful to law enforcement for AML monitoring. Incidents came to light last year about access to European institutions and government data through SWIFT, and criticism about privacy concerns and discussion were had with the EU about law enforcement’s continuing access to such information. A proposal to report on all wires outside the US regardless of dollar amount was defeated due to compliance cost concerns, and given that SARs were sufficient for reporting this information to law enforcement. One of the missions of FinCEN was to create a data warehouse accessible to law enforcement for AML and anti-terrorism efforts. This report is part of that goal to identify what FinCEN views as high risk transactions. The report recommends that this system be created but certain issues need to be reviewed. Other agencies served on the committee that produced the report, including the Institute of International Bankers. The basic recommendation was that although the existing system may be sufficient, the addition of a cross-border data transfer reporting system would enhance law enforcement capabilities. But, reporting should only apply to $3,000 or higher, not have a cumulative effect of adding up smaller transfers, and be created on a first in, last out basis (i.e., no intermediate transferees would need to report). There is a concern that there could be a shift away from US dollar based transaction to avoid the reporting. Once the data is available, it will be matched against CTRs, SARs and other reports and databases. The report also discusses privacy concerns. It appears that this will be implemented, but this will take at least a year before there is any move toward implementation.

A memo from the Institute of International Bankers, including directions for obtaining a copy of the Report, is attached.

10. Legislative Subcommittee – State Legislative Issues: Bart Dzivi reported to the Committee on legislative issues, as follows: Below is Bart's handout on legislative action pending as of this year.

<u>Technical Amendment to Regulatory Relief Bill. Pub. L. No. 109-473</u>. On January 11th, President Bush signed into law an amendment to the regulatory relief legislation that was adopted last year. The purpose of the legislation was to allow Banks with a CAMEL 2 rating and assets less than $500 million to have an 18 month exam schedule.

<u>Student Loans. H.R. 5</u>. College Student Relief Act of 2007. As part of its first 100 hours agenda, the House approved the bill by a vote of 356-71 on Jan. 17. The bill would reduce borrowing costs for need-based Stafford loans from the present 6.8 percent interest rate to 3.4 percent over 5 years. Interest rates would drop to 6.12 percent in 2007, 5.44 percent in 2008, 4.76 percent in 2009, 4.08 percent in 2010 and 3.4 percent in 2011. In 2012, a new rate would be set. To offset the estimated $6 billion cost of the interest rate reduction on this specific type of student loan, the bill will increase the fees paid by student loan providers. The Administration has indicated it is opposed to H.R. 5, and in the long term budget it recently released, it proposed a series of measures that would cost lenders between 3 and 5 times the amount provided in H.R. 5. Sen. Kennedy is spearheading legislation in the Senate, and introduced S. 359, the Student Debt Relief Act, on January 22nd, which not only includes provisions aimed at lowering interest rates for students, but also expands Pell grants from $4,050 to $5,100.

<u>CTR Filing. H.R. 323</u>. Seasoned Customer CTR Exemption Act of 2007. On January 23rd, the House adopted the bill by voice vote. The bill would require the Treasury Department to adopt a regulation exempting transactions between banks and customers that have maintained a deposit account for at least 12 months. A similar bill passed the House last year but was not approved by the Senate.

<u>Reverse Mortgages. HR. 391</u>. On January 16th, the House adopted the bill by voice vote. The bill would temporarily suspend until February 15, 2007, the current cap that limits the Housing and Urban Development Department to insuring only 275,000 reverse mortgages. A companion measure introduced by the same sponsor, H.R. 568, would permanently eliminate the cap.

<u>Industrial Loan Companies. H.R. 698</u>. Industrial Bank Holding Company Act of

2007. Incoming Financial Services Committee Chairman Barney Frank introduced a bill with bipartisan sponsorship that would bar companies such as Wal-Mart from being the parent of an ILC. The bill prevents a company from acquiring or establishing an ILC if 15 percent of the annual gross revenues were derived from engaging in activities that are not financial in nature or incidental to a financial activity.

FDIC Insurance. H.R. 382. Municipal Deposit Insurance Protection Act of 2007. Introduced on January 10th, this bill would raise the FDIC deposit insurance limit for municipal deposits. In essence, coverage of municipal deposits in excess of the current $100,000 limit would be 80% of the deposit amount; provided that total insurance coverage would be capped at $2 million per depositor. Such expanded coverage would be available for any municipality that is in the same state as the branch or office at which the deposits are held.

Business Checking. H.R. 41. The Business Checking Fairness Act of 2007. Introduced on January 4th, the legislation would allow banks to offer interest on business checking accounts 2 years after enactment. Upon enactment, the bill would also increase the number of permitted sweeps in a checking account from 6 to 24 transfers per month (or such greater number as the Board of Governors of the Federal Reserve System may determine by rule or order).

Bart also commented on the following with respect to process in Washington given control of the House and Senate by the Democrats. Democrats did not expect to win control of the Senate. Senator Dodd, its Chairman, will probably be emphasizing pro-consumer legislation in the Senate Banking Committee. Senators Dodd and Shelby should have a good working relationship and ease the legislative process. On the House side, Barney Frank is in leadership and the staff remains unchanged. Congressman Frank was pro-housing which should continue, and there should be some focus on increased disclosure for both credit card and home mortgage issues.

11. Open Meeting, Other Items of Interest:

(a) Will Stern reported on *Laliberte vs. Pacific Mercantile Bank* (copy attached). After *Turner vs. Beneficial* (2001) 534 U.S. 820, and its line of cases, actual damage class actions under the Truth in Lending Act (TILA) had come to an end. There remains a split in the courts whether you can maintain a class action for a rescission claim under TILA. *Laliberte* holds that no rescission class action claims may be maintained under TILA based on the premise that Congress' $500,000 cap on damage claims should apply to rescission claims as well. Thus, in California and those jurisdictions that follow this case, for institutions with a TILA violation that permeates more than a single contract, liability exposure is limited to damages only on a class-wide basis, and capped at $500,000.

(b) Rosie reminded those in attendance that our March 13 meeting will be in Sacramento, with lunch to follow at the Broiler Steak House (1201 K St # 100, Sacramento, CA 95814, (916) 444-3444). Lunch will be provided by the Bar. The Commissioner of the Department of Financial Institutions has agreed to speak at lunch. A hearing room has been reserved for the meeting but legislators or their staff who will attend have not yet been identified. Rosie will investigate the train schedule and advise about transportation availability.

The meeting was adjourned at 11:35 am. Next meeting: March 13, 2007 in Sacramento.

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The New Deposit Insurance Assessment System

February 13, 2007

William F. Kroener, III

Financial Institutions Committee
Business Law Section
State Bar of California

Outline

I. **Background**

II. **FDIC Implementation**

- **Details of Assessment System**
- **Assessment Credit**
- **Temporary Exemption for New Growth Institutions**

III. **DRR Determination, Refund / Collection by FDIC and Other Changes**

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I. Background

1. **Deposit Insurance Reform Act of 2005 (enacted in early 2006, as was a technical corrections act)**

2. **Extensive 1996 – 2005 Background – Rate Differentials, Oakar Institutions, Absence of Premiums, Debates over Credit for Past Contributions and "Fast Growth" Problem**

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II. FDIC Implementation

1. **Merger of BIF and SAIF into DIF – 3/31/06**
2. **New, More Complex System for Assessment of Insurance Premiums – Effective 1/1/07**
3. **Assessment Credit for Past Contributions**
4. **Temporary Exemption for New Institutions**

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II. FDIC Implementation (cont'd)

Merger of BIF and SAIF into DIF

- Accomplished by FDIC as of March 31, 2006.
- Reserve Ratio Combined – 1.25%

II. FDIC Implementation (cont'd)

New System for Deposit Insurance Assessments

- Much more complex
- All banks pay something (unlike prior decade)
- Two-tiered system based on size
  - 10 billion and above (ratings based)
  - All others (financial ratio based)

Details of Assessment System

Old System:

Capital Group	Supervisory Subgroup A	Supervisory Subgroup B	Supervisory Subgroup C
1. Well Capitalized	1A	1B	1C
2. Adequately Capitalized	2A	2B	2C
3. Undercapitalized	3A	3B	3C

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Details of Assessment System (cont'd)

New System:

Capital Group	Supervisory Subgroup A	Supervisory Subgroup B	Supervisory Subgroup C
Well Capitalized	I		
Adequately Capitalized		II	III
Undercapitalized		III	IV

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Details of Assessment System (cont'd)

Risk Category I

Large (equal to or more than $10 Billion)

- Long-Term Issuer Ratings

Small (less than $10 billion or no long-term debt rating)

Financial Ratios (with weighted multipliers)

- Tier 1 leverage ratio
- 30 – 89 days past due / gross assets
- Nonperforming / gross assets
- Pre-tax income / risk weighted assets

All – Camel Ratings (weighed multipliers – C and M - 25%, A - 20%, ELS – 10%)

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III. Details of Assessment System (cont'd)

Other Complex Calculations (mathematician notations)

- "Additional Adjustments"
- In consultation with primary regulator
  - Current financial performance
  - Current market indicators
  - Current loss severity indicators

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Details of Assessment System (cont'd)

New Base Rates

	Risk Category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)……………………	2	4	7	25	40

*Rates for institutions that do not pay the minimum or maximum rate vary between these rates.

New Actual Rates for 2007 – Up 3 basis points

	Risk Category				
	I*		II	III	IV
	Minimum	Maximum			
Annual Rates (in basis points)……………………	5	7	10	28	43

*Rates for institutions that do not pay the minimum or maximum rate vary between these rates.

FDIC can vary up/down 5 basis points from base without new rule making

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Details of Assessment System (cont'd)

Assessment Credit

For Those That Paid-In Prior to 1996

- Issue of Entitlement in Case of Deposit Transfers
  - Transferor – Paid
  - Transferee – Owner of Deposits
- FDIC Resolution in Final Rule
  - Generally transferor, except where transfer is of all or substantially all (90%) deposits
  - Credits are transferable

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Details of Assessment System (cont'd)

Temporary Exemption for New Institutions

- Background of Issue
  - 1996 – 2005 Institutions
  - Rapid Growth of Some
  - Early failure concerns
  - Absence of Credit
  - Going forward, new institutions in highest category of Risk Level I
  - Delay implementation until 1/1/10

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III. DRR Determination, and Refund/ Collection by FDIC and Other Changes

- Historically, Designated Reserve Ratio has been 1.25% of Estimated Insured Deposits
  - Source – uncertain
    - 1996 Funds Act Hardwiring
    - FDIC push for a range, resulting in new range of 1.15% to 1.35%
- New DRR – 1.25%

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III. DRR Determination, and Refund/ Collection by FDIC and Other Changes (cont'd)

- **Structure =**

1. **If below 1.15, FDIC must assess**
2. **If above 1.35, FDIC must refund 50%**
3. **If above 1.50, FDIC must refund 100% unless**
4. **Dividends – Theoretical in Short Term but FDIC adopted a temporary two year rule**

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Some Other Changes

Operational Rule –

- **Timing of Assessments from Semi-Annual to Quarterly**
- **Timing of Ratings Changes More Current**
- **Assessment Base Changes to Average Daily Balances ($1 billion or more) and Eliminate Float Deduction**

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Citations

BIF-SAIF Merger Rule Changes, 71 Fed. Reg. 20524 (4/21/06)

Assessment Credits, 71 Fed. Reg. 61374 (10/18/06)

Assessment Dividends, 71 Fed. Reg. 61395 (10/18/06)

Failure to Pay Penalty, 71 Fed. Reg. 65711 (11/9/06)

Operational Rule, 71 Fed. Reg. 69270 (11/30/06)

Final Assessment Rule, 71 Fed. Reg. 69283 (11/30/06)

DRR Determination, 71 Fed. Reg. 69323 (11/30/06)

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Agenda Item #5

Meg Trough Report on IOLTA –

Redline Version of Business and Profession Code Sections

~~CALIFORNIA CODES~~
~~BUSINESS AND **PROFESSIONS CODE**~~
~~SECTION **6210**-6228~~

§ 6210. Legislative findings; purpose

The Legislature finds that, due to insufficient funding, existing programs providing free legal services in civil matters to indigent persons, especially underserved client groups, such as the elderly, the disabled, juveniles, and non-English-speaking persons, do not adequately meet the needs of these persons. It is the purpose of this article to expand the availability and improve the quality of existing free legal services in civil matters to indigent persons, and to initiate new programs that will provide services to them. The Legislature finds that the use of funds collected by the State Bar pursuant to this article for these purposes is in the public interest, is a proper use of the funds, and is consistent with essential public and governmental purposes in the judicial branch of government. The Legislature further finds that the expansion, improvement, and initiation of legal services to indigent persons will aid in the advancement of the science of jurisprudence and the improvement of the administration of justice.

§ 6211. Establishment by attorney of trust account; interest and dividends earned to be paid to state bar; other accounts not prohibited; rules of professional conduct, authority of supreme court or state bar not affected

~~6211.~~ (a) An attorney or law firm, which in the course of the practice of law receives or disburses trust funds, shall establish and maintain an ~~interest bearing demand trust~~IOLTA account and shall deposit therein all client deposits that are nominal in amount or are on deposit for a short period of time. All such client funds may be deposited in a single unsegregated account. The interest and dividends earned on all such accounts shall be paid to the State Bar of California to be used for the purposes set forth in this article.

(b) Nothing in this article shall be construed to prohibit an attorney or law firm from establishing one or more interest- or dividend- bearing bank accounts or other trust investments as may be permitted by the Supreme Court, with the interest or dividends earned on the accounts payable to clients for trust funds not deposited in accordance with subdivision (a).

(c) With the approval of the Supreme Court, the State Bar may formulate and enforce rules of professional conduct pertaining to the use by attorneys or law firms of ~~interest bearing trust~~ IOLTA accounts for unsegregated client funds pursuant to this article.

(d) Nothing in this article shall be construed as affecting or impairing the disciplinary powers and authority of the Supreme Court or of the State Bar or as modifying the statutes and rules governing the conduct of members of the State Bar.

§ 6212. Establishment by attorney of demand trust account; amount of interest; remittance to state bar; statements and reports

~~6212.~~ An attorney who, or a law firm which, establishes an ~~interestbearing demand trust~~IOLTA account pursuant to subdivision (a) of Section 6211 shall comply with all of the following provisions:

(a) The ~~interest bearing trust~~IOLTA account shall be established ~~with a~~and maintained with an eligible institution that meets the requirements of this section 6212. . ~~bank or such other financial institutions as are authorized by the Supreme Court.~~

~~(b) The rate of interest payable on any interest bearing demand trust account shall not be less than the rate paid by the depository institution to regular, nonattorney depositors. Higher rates offered by the institution to customers whose deposits exceed certain time or quantity qualifications, such as those offered in the form of certificates of deposit, may be obtained by an attorney or law firm so long as there is no impairment of the right to withdraw or transfer principal immediately (except as accounts generally may be subject to statutory notification requirements), even though interest may be sacrificed thereby.~~

(b) The rate of interest or dividends payable on any IOLTA account shall not be less than the rate or dividends paid by the eligible institution to regular, nonattorney, depositors having the same minimum balance and meeting the same eligibility requirements as the IOLTA account. In determining the highest interest rate or dividend generally available from the eligible institution to its non-IOLTA customers, an eligible institution may consider, in addition to the balance in the IOLTA account, factors customarily considered by the eligible institution when setting the interest rate or dividends for its non-IOLTA customers, provided that such factors do not discriminate between IOLTA accounts and non-IOLTA accounts and that these factors do not include the fact that the account is an IOLTA account. The eligible institution shall calculate interest and dividends in accordance with its standard practice for non-IOLTA customers. An eligible institution may choose to pay the higher interest rate or dividend on an IOLTA account in lieu of establishing it as a higher rate product. Nothing in this section shall preclude an eligible institution from paying a higher interest rate or dividend on an IOLTA account or from electing to waive any fees and service charges on an IOLTA account.

(c) Allowable reasonable fees may be deducted from interest or dividends on an IOLTA account only at the rates and in accordance with the customary practices of the eligible institution for non-IOLTA customers. No other fees or service charges may be assessed against the interest or dividends earned on an IOLTA account. Any fees and service charges other than allowable reasonable fees shall be the sole responsibility of, and may only be charged to, the lawyer or law firm maintaining the IOLTA account. Fees and service charges in excess of the interest or dividends earned on one IOLTA account for any period shall not be taken from the interest or dividends earned on any other IOLTA account or accounts or from the principal of any IOLTA account.

~~(c~~(d) The ~~depository~~eligible institution shall be directed to do all of the following:

(1) To remit interest or dividends s on the ~~average daily balance in the~~IOLTA account, less allowable reasonable ~~service charges~~fees, to the State Bar, at least quarterly.

(2) To transmit to the State Bar with each remittance a statement showing the name of the attorney or law firm for whom the remittance is sent~~,~~ and for each account the rate of interest or dividend applied, ~~and~~ the amount of interest or dividends earned and the amount of fees or service charges deducted, if any, and the average balance for each account for each month of the period for which the report is made.

(3) To transmit to the depositing attorney or law firm at the same time a report showing the amount paid to the State Bar for that period, the rate of interest or dividend applied, the amount of service charges deducted, if any, and the average daily account balance for each month of the period for which the report is made.

§ 6213. Definitions

As used in this article:

(a) "Qualified legal services project" means either of the following:

(1) A nonprofit project incorporated and operated exclusively in California which provides as its primary purpose and function legal services without charge to indigent persons and which has quality control procedures approved by the State Bar of California.

(2) A program operated exclusively in California by a nonprofit law school accredited by the State Bar of California which meets the requirements of subparagraphs (A) and (B).

(A) The program shall have operated for at least two years at a cost of at least twenty thousand dollars ($20,000) per year as an identifiable law school unit with a primary purpose and function of providing legal services without charge to indigent persons.

(B) The program shall have quality control procedures approved by the State Bar of California.

(b) "Qualified support center" means an incorporated nonprofit legal services center, which has as its primary purpose and function the provision of legal training, legal technical assistance, or advocacy support without charge and which actually provides through an office in California a significant level of legal training, legal technical assistance, or advocacy support without charge to qualified legal services projects on a statewide basis in California.

(c) "Recipient" means a qualified legal services project or support center receiving financial assistance under this article.

(d) "Indigent person" means a person whose income is (1) 125 percent or less of the current poverty threshold established by the United States Office of Management and Budget, or (2) who is eligible for Supplemental Security Income or free services under the Older Americans Act or Developmentally Disabled Assistance Act. With regard to a project which provides free services of attorneys in private practice without compensation, "indigent person" also means a person whose income is 75 percent or less of the maximum levels of income for lower income households as defined in Section 50079.5 of the Health and Safety Code. For the purpose of this subdivision, the income of a person who is disabled shall be determined after deducting the costs of medical and other disability-related special expenses.

(e) "Fee generating case" means any case or matter which, if undertaken on behalf of an indigent person by an attorney in private practice, reasonably may be expected to result in payment of a fee for legal services from an award to a client, from public funds, or from the opposing party. A case shall not be considered fee generating if adequate representation is unavailable and any of the following circumstances exist:

(1) The recipient has determined that free referral is not possible because of any of the following reasons:

(A) The case has been rejected by the local lawyer referral service, or if there is no such service, by two attorneys in private practice who have experience in the subject matter of the case.

(B) Neither the referral service nor any attorney will consider the case without payment of a consultation fee.

(C) The case is of the type that attorneys in private practice in the area ordinarily do not accept, or do not accept without prepayment of a fee.

(D) Emergency circumstances compel immediate action before referral can be made, but the client is advised that, if appropriate and consistent with professional responsibility, referral will be attempted at a later time.

(2) Recovery of damages is not the principal object of the case and a request for damages is merely ancillary to an action for equitable or other nonpecuniary relief, or inclusion of a counterclaim requesting damages is necessary for effective defense or because of applicable rules governing joinder of counterclaims.

(3) A court has appointed a recipient or an employee of a recipient pursuant to a statute or a court rule or practice of equal applicability to all attorneys in the jurisdiction.

(4) The case involves the rights of a claimant under a publicly supported benefit program for which entitlement to benefit is based on need.

(f) "Legal Services Corporation" means the Legal Services Corporation established under the Legal Services Corporation Act of 1974 (Public Law 93- 355; 42 U.S.C. Sec. 2996 et seq.).

(g) "Older Americans Act" means the Older Americans Act of 1965, as amended (Public Law 89-73; 42 U.S.C. Sec. 3001 et seq.).

(h) "Developmentally Disabled Assistance Act" means the Developmentally Disabled Assistance and Bill of Rights Act of 1975, as amended (Public Law 94- 103; 42 U.S.C. Sec. 6001 et seq.).

(i) "Supplemental security income recipient" means an individual receiving or eligible to receive payments under Title XVI of the federal Social Security Act, or payments under Chapter 3 (commencing with Section 12000) of Part 3 of Division 9 of the Welfare and Institutions Code.

(j) "IOLTA account" means (1) an interest-bearing checking account, (2) an investment sweep product that is a daily (overnight) financial institution repurchase agreement or an open-end money-market fund, or (3) any other investment product authorized by California Supreme Court rule or order. A daily financial institution repurchase agreement must be fully collateralized by U.S. Government Securities and may be established only with an eligible institution that is "well-capitalized" or "adequately capitalized" as those terms are defined by applicable federal statutes and regulations. An open-end money-market fund must be invested solely in U.S. Government Securities or repurchase agreements fully collateralized by U.S. Government Securities, must hold itself out as a "money-market fund" as that term is defined by federal statutes and regulations under the Investment Company Act of 1940, and, at the time of the investment, must have total assets of at least $250,000,000. U.S. Government Securities, for the purposes of this section, include securities of Government Sponsored Entities, including but not limited to Federal National Mortgage Association securities, Government National Mortgage Association securities, and Federal Home Loan Mortgage Corporation Securities.

(k) "Eligible institution" means a bank or such other financial institutions as are authorized by the Supreme Court.

(l) "Allowable reasonable fees" means (1) per-check charges; (2) per-deposit charges; (3) a fee in lieu of minimum balance, (4) federal deposit insurance fees, (5) sweep fees, and (6) a reasonable IOLTA account administrative or maintenance fee. Fees or service charges that are not "allowable reasonable fees" include, but are not limited to, the cost of check printing, deposit stamps, NSF charges, collection charges, and fees for cash management.

§ 6214. Qualified legal service projects

(a) Projects meeting the requirements of subdivision (a) of Section 6213 which are funded either in whole or part by the Legal Services Corporation or with Older American Act funds shall be presumed qualified legal services projects for the purpose of this article.

(b) Projects meeting the requirements of subdivision (a) of Section 6213 but not qualifying under the presumption specified in subdivision (a) shall qualify for funds under this article if they meet all of the following additional criteria:

(1) They receive cash funds from other sources in the amount of at least twenty thousand dollars ($20,000) per year to support free legal representation to indigent persons.

(2) They have demonstrated community support for the operation of a viable ongoing program.

(3) They provide one or both of the following special services:

(A) The coordination of the recruitment of substantial numbers of attorneys in private practice to provide free legal representation to indigent persons or to qualified legal services projects in California.

(B) The provision of legal representation, training, or technical assistance on matters concerning special client groups, including the elderly, the disabled, juveniles, and non-English-speaking groups, or on matters of specialized substantive law important to the special client groups.

§ 6214.5. Qualified legal services projects; eligibility for distributions of funds

A law school program that meets the definition of a "qualified legal services project" as defined in paragraph (2) of subdivision (a) of Section 6213, and that applied to the State Bar for funding under this article not later than February 17, 1984, shall be deemed eligible for all distributions of funds made under Section 6216.

§ 6215. Qualified support centers

(a) Support centers satisfying the qualifications specified in subdivision (b) of Section 6213 which were operating an office and providing services in California on December

31, 1980, shall be presumed to be qualified support centers for the purposes of this article.

(b) Support centers not qualifying under the presumption specified in subdivision (a) may qualify as a support center by meeting both of the following additional criteria:

(1) Meeting quality control standards established by the State Bar.

(2) Being deemed to be of special need by a majority of the qualified legal services projects.

§ 6216. Distribution of funds

The State Bar shall distribute all moneys received under the program established by this article for the provision of civil legal services to indigent persons. The funds first shall be distributed 18 months from the effective date of this article, or upon such a date, as shall be determined by the State Bar, that adequate funds are available to initiate the program. Thereafter, the funds shall be distributed on an annual basis. All distributions of funds shall be made in the following order and in the following manner:

(a) To pay the actual administrative costs of the program, including any costs incurred after the adoption of this article and a reasonable reserve therefor.

(b) Eighty-five percent of the funds remaining after payment of administrative costs allocated pursuant to this article shall be distributed to qualified legal services projects. Distribution shall be by a pro rata county-by-county formula based upon the number of persons whose income is 125 percent or less of the current poverty threshold per county. For the purposes of this section, the source of data identifying the number of persons per county shall be the latest available figures from the United States Department of Commerce, Bureau of the Census. Projects from more than one county may pool their funds to operate a joint, multicounty legal services project serving each of their respective counties.

(1) (A) In any county which is served by more than one qualified legal services project, the State Bar shall distribute funds for the county to those projects which apply on a pro rata basis, based upon the amount of their total budget expended in the prior year for legal services in that county as compared to the total expended in the prior year for legal services by all qualified legal services projects applying therefor in the county. In determining the amount of funds to be allocated to a qualified legal services project specified in paragraph (2) of subdivision (a) of Section 6213, the State Bar shall recognize only expenditures attributable to the representation of indigent persons as constituting the budget of the program.

(B) The State Bar shall reserve 10 percent of the funds allocated to the county for distribution to programs meeting the standards of subparagraph (A) of paragraph (3) and paragraphs (1) and (2) of subdivision (b) of Section 6214 and which perform the services described in subparagraph (A) of paragraph (3) of Section 6214 as their principal means of delivering legal services. The State Bar shall distribute the funds for that county to those programs which apply on a pro rata basis, based upon the amount of their total budget expended for free legal services in that county as compared to the total expended for free legal services by all programs meeting the standards of subparagraph (A) of paragraph (3) and paragraphs (1) and (2) of subdivision (b) of Section 6214 in that county. The State Bar shall distribute any funds for which no program has qualified pursuant hereto, in accordance with the provisions of subparagraph (A) of paragraph (1) of this subdivision.

(2) In any county in which there is no qualified legal services projects providing services, the State Bar shall reserve for the remainder of the fiscal year for distribution the pro rata share of funds as provided for by this article. Upon application of a qualified legal services project proposing to provide legal services to the indigent of the county, the State Bar shall distribute the funds to the project. Any funds not so distributed shall be added to the funds to be distributed the following year.

(c) Fifteen percent of the funds remaining after payment of administrative costs allocated for the purposes of this article shall be distributed equally by the State Bar to qualified support centers which apply for the funds. The funds provided to support centers shall be used only for the provision of legal services within California. Qualified support centers that receive funds to provide services to qualified legal services projects from sources other than this article, shall submit and shall have approved by the State Bar a plan assuring that the services funded under this article are in addition to those already funded for qualified legal services projects by other sources.

§ 6217. Maintenance of quality services, professional standards, attorney-client privilege; funds to be expended in accordance with article; interference with attorney prohibited

~~6217.~~ With respect to the provision of legal assistance under this article, each recipient shall ensure all of the following:

(a) The maintenance of quality service and professional standards.

(b) The expenditure of funds received in accordance with the provisions of this article.

(c) The preservation of the attorney-client privilege in any case, and the protection of the integrity of the adversary process from any impairment in furnishing legal assistance to indigent persons.

(d) That no one shall interfere with any attorney funded in whole or in part by this article in carrying out his or her professional responsibility to his or her client as established by the rules of professional responsibility and this chapter.

~~6218.~~ **§ 6218. Eligibility for services; establishment of guidelines; funds to be expended in accordance with article**

All legal services projects and support centers receiving funds pursuant to this article shall adopt financial eligibility guidelines for indigent persons.

(a) Qualified legal services programs shall ensure that funds appropriated pursuant to this article shall be used solely to defray the costs of providing legal services to indigent persons or for such other purposes as set forth in this article.

(b) Funds received pursuant to this article by support centers shall only be used to provide services to qualified legal services projects as defined in subdivision (a) of Section 6213 which are used pursuant to a plan as required by subdivision (c) of Section 6216, or as permitted by Section 6219.

§ 6219. Provision of work opportunities and scholarships for disadvantaged law students

~~6219.~~ Qualified legal services projects and support centers may use funds provided under this article to provide work opportunities with pay, and where feasible, scholarships for disadvantaged law students to help defray their law school expenses.

§ 6220. Private attorneys providing legal services without charge; support center services

~~6220.~~ Attorneys in private practice who are providing legal services without charge to indigent persons shall not be disqualified from receiving the services of the qualified support centers.

§ 6221. Services for indigent members of disadvantaged and underserved groups

~~6221.~~ Qualified legal services projects shall make significant efforts to utilize 20 percent of the funds allocated under this article for increasing the availability of services to the elderly, the disabled, juveniles, or other indigent persons who are members of disadvantaged and underserved groups within their service area.

§ 6222. Financial statements; submission to state bar; state bar report

~~6222.~~ A recipient of funds allocated pursuant to this article annually shall submit a financial statement to the State Bar, including an audit of the funds by a certified public accountant or a fiscal review approved by the State Bar, a report demonstrating the programs on which they were expended, a report on the recipient's compliance with the requirements of Section 6217, and progress in meeting the service expansion requirements of Section 6221.

The Board of Governors of the State Bar shall include a report of receipts of funds under this article, expenditures for administrative costs, and disbursements of the funds, on a county-by-county basis, in the annual report of State Bar receipts and expenditures required pursuant to Section 6145.

§ 6223. Expenditure of funds; prohibitions

No funds allocated by the State Bar pursuant to this article shall be used for any of the following purposes:

(a) The provision of legal assistance with respect to any fee generating case, except in accordance with guidelines which shall be promulgated by the State Bar.

(b) The provision of legal assistance with respect to any criminal proceeding.

(c) The provision of legal assistance, except to indigent persons or except to provide support services to qualified legal services projects as defined by this article.

§ 6224. State bar; powers; determination of qualifications to receive funds; denial of funds; termination; procedures

~~6224.~~ The State Bar shall have the power to determine that an applicant for funding is not qualified to receive funding, to deny future funding, or to terminate existing funding because the recipient is not operating in compliance with the requirements or restrictions of this article.

A denial of an application for funding or for future funding or an action by the State Bar to terminate an existing grant of funds under this article shall not become final until the applicant or recipient has been afforded reasonable notice and an opportunity for a timely and fair hearing. Pending final determination of any hearing held with reference to termination of funding, financial assistance shall be continued at its existing level on a month-to-month basis. Hearings for denial shall be conducted by an impartial hearing officer whose decision shall be final. The hearing officer shall render a decision no later than 30 days after the conclusion of the hearing. Specific procedures governing the conduct of the hearings of this section shall be determined by the State Bar pursuant to Section 6225.

§ 6225. Implementation of article; adoption of rules and regulations; procedures

~~6225.~~ The Board of Governors of the State Bar shall adopt the regulations and procedures necessary to implement this article and to ensure that the funds allocated herein are utilized to provide civil legal services to indigent persons, especially underserved client groups such as but not limited to the elderly, the disabled, juveniles, and non-English-speaking persons.

In adopting the regulations the Board of Governors shall comply with the following procedures:

(a) The board shall publish a preliminary draft of the regulations and procedures, which shall be distributed, together with notice of the hearings required by subdivision (b), to commercial banking institutions, to members of the State Bar, and to potential recipients of funds.

(b) The board shall hold at least two public hearings, one in southern California and one in northern California where affected and interested parties shall be afforded an opportunity to present oral and written testimony regarding the proposed regulations and procedures.

§ 6226. Implementation of article; resolution

The program authorized by this article shall become operative only upon the adoption of a resolution by the Board of Governors of the State Bar stating that regulations have been adopted pursuant to Section 6225 which conform the program to all applicable tax and banking statutes, regulations, and rulings.

§ 6227. Credit of state not pledged

Nothing in this article shall create an obligation or pledge of the credit of the State of California or of the State Bar of California. Claims arising by reason of acts done pursuant to this article shall be limited to the moneys generated hereunder.

§ 6228. Severability

If any provision of this article or the application thereof to any group or circumstances is held invalid, such invalidity shall not affect the other provisions or applications of this article which can be given effect without the invalid provision or application, and to this end the provisions of this article are severable.

6091.1. Overdrafts and misappropriations from attorney trust accounts; reports by financial institutions

(a) The Legislature finds that overdrafts and misappropriations from attorney trust accounts are serious problems, and determines that it is in the public interest to ensure prompt detection and investigation of instances involving overdrafts and misappropriations from attorney trust accounts.

A financial institution, including any branch, which is a depository for attorney trust accounts under subdivision (a) or (b) of Section 6211, shall report to the State Bar in the event any properly payable instrument is presented against an attorney trust account containing insufficient funds, irrespective of whether or not the instrument is honored.

(b) All reports made by the financial institution shall be in the following format:

(1) In the case of a dishonored instrument, the report shall be identical to the overdraft notice customarily forwarded to the depositor, and shall include a copy of the dishonored instrument, if such a copy is normally provided to depositors.

(2) In the case of instruments that are presented against insufficient funds but which instruments are honored, the report shall identify the financial institution, the attorney or law firm, the account number, the date of presentation for payment, and the date paid, as well as the amount of overdraft created thereby. These reports shall be made simultaneously with, and within the time provided by law for notice of dishonor, if any. If an instrument presented against insufficient funds is honored, then the report shall be made within five banking days of the date of presentation for payment against insufficient funds.

(c) Every attorney practicing or admitted to practice in this state shall, as a condition thereof, be conclusively deemed to have consented to the reporting and production requirements of this section.

(d) Nothing in this section shall preclude a financial institution from charging an attorney or law firm for the reasonable cost of producing the reports and records required by subdivisions (a) and (b).

§ 6091.2. Definitions applicable to § 6091.1

As used in Section 6091.1:

(a) "Financial institution" means a bank, savings and loan, or other financial institution serving as a depository for attorney trust accounts under Section 6211 (a) or (b).

(b) "Properly payable" means an instrument which, if presented in the normal course of business, is in a form requiring payment under the laws of this state.

(c) "Notice of dishonor" means the notice which a financial institution is required to give, under the laws of this state, upon presentation of an instrument which the institution dishonor.

DEPARTMENT OF THE TREASURY
Office of the Comptroller of the Currency
[Docket No. 06-11]

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
[Docket No. OP-1246]

FEDERAL DEPOSIT INSURANCE CORPORATION

DEPARTMENT OF THE TREASURY
Office of Thrift Supervision
[No. 2006-35]

NATIONAL CREDIT UNION ADMINISTRATION

Interagency Guidance on Nontraditional Mortgage Product Risks

AGENCIES: Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); Office of Thrift Supervision, Treasury (OTS); and National Credit Union Administration (NCUA).

ACTION: Final guidance.

SUMMARY: The OCC, Board, FDIC, OTS, and NCUA (the Agencies), are issuing final Interagency Guidance on Nontraditional Mortgage Product Risks (guidance). This guidance has been developed to clarify how institutions can offer nontraditional mortgage products in a safe and sound manner, and in a way that clearly discloses the risks that borrowers may assume.

FOR FURTHER INFORMATION CONTACT:
OCC: Gregory Nagel, Credit Risk Specialist, Credit and Market Risk, (202) 874-5170; or Michael S. Bylsma, Director, or Stephen Van Meter, Assistant Director, Community and Consumer Law Division, (202) 874-5750.
Board: Brian Valenti, Supervisory Financial Analyst, (202) 452-3575; or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521; or Sabeth I. Siddique, Assistant Director, (202) 452-3861, Division of Banking Supervision and Regulation; Kathleen C. Ryan, Counsel, Division of Consumer and Community Affairs, (202) 452-3667; or Andrew Miller, Counsel, Legal Division, (202) 452-3428. For users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

FDIC: Suzy S. Gardner, Examination Specialist, (202) 898-3640, or April Breslaw, Chief, Compliance Section, (202) 898-6609, Division of Supervision and Consumer Protection; or Ruth R. Amberg, Senior Counsel, (202) 898-3736, or Richard Foley, Counsel, (202) 898-3784, Legal Division.
OTS: William Magrini, Senior Project Manager, Examinations and Supervision Policy, (202) 906-5744; or Fred Phillips-Patrick, Director, Credit Policy, (202) 906-7295; or Glenn Gimble, Senior Project Manager, Compliance and Consumer Protection, (202) 906-7158.
NCUA**:** Cory Phariss, Program Officer, Examination and Insurance, (703) 518-6618.

SUPPLEMENTARY INFORMATION:

I. Background

The Agencies developed this guidance to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. These products, referred to variously as “nontraditional,” “alternative,” or “exotic” mortgage loans (hereinafter referred to as nontraditional mortgage loans), include “interest-only” mortgages and “payment option” adjustable-rate mortgages. These products allow borrowers to exchange lower payments during an initial period for higher payments during a later amortization period.

While similar products have been available for many years, the number of institutions offering them has expanded rapidly. At the same time, these products are offered to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgages. The Agencies are concerned that some borrowers may not fully understand the risks of these products. While many of these risks exist in other adjustable-rate mortgage products, the Agencies’ concern is elevated with nontraditional products because of the lack of principal amortization and potential for negative amortization. In addition, institutions are increasingly combining these loans with other features that may compound risk. These features include simultaneous second-lien mortgages and the use of reduced documentation in evaluating an applicant’s creditworthiness.

In response to these concerns, the Agencies published for comment proposed Interagency Guidance on Nontraditional Mortgage Products, 70 FR 77249 (Dec. 29, 2005). The Agencies proposed guidance in three primary areas: “Loan Terms and Underwriting Standards,” “Portfolio and Risk Management Practices,” and “Consumer Protection Issues.” In the first section, the Agencies sought to ensure that loan terms and underwriting standards for nontraditional mortgage loans are consistent with prudent lending practices, including credible consideration of a borrower’s repayment capacity. The portfolio and risk management practices section outlined the need for strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio. Finally, the consumer protection issues section recommended practices to ensure consumers have clear and balanced information prior to making a product choice. Additionally, this section described control systems to ensure that actual practices are consistent with policies and procedures.

The Agencies together received approximately 100 letters in response to the proposal.[1] Comments were received from financial institutions, trade associations, consumer and community organizations, state financial regulatory organizations, and other members of the public.

II. Overview of Public Comments

The Agencies received a full range of comments. Some commenters applauded the Agencies' initiative in proposing the guidance, while others questioned whether guidance is needed.

A majority of the depository institutions and industry groups that commented stated that the guidance is too prescriptive. They suggested institutions should have more flexibility in determining appropriate risk management practices. A number observed that nontraditional mortgage products have been offered successfully for many years. Others opined that the guidance would stifle innovation and result in qualified borrowers not being approved for these loans. Further, many questioned whether the guidance is an appropriate mechanism for addressing the Agencies' consumer protection concerns.

A smaller subset of commenters argued that the guidance does not go far enough in regulating or restricting nontraditional mortgage products. These commenters included consumer organizations, individuals, and several community bankers. Several stated these products contribute to speculation and unsustainable appreciation in the housing market. They expressed concern that severe problems will occur if and when there is a downturn in the economy. Some also argued that these products are harmful to borrowers and that borrowers may not understand the associated risks.

Many commenters voiced concern that the guidance will not apply to all lenders, and thus federally regulated financial institutions will be at a competitive disadvantage. The Agencies note that both state financial regulatory organizations that commented on the proposed guidance – the Conference of State Bank Supervisors (CSBS) and the State Financial Regulators Roundtable (SFRR) – committed to working with state regulatory agencies to distribute guidance that is similar in nature and scope to the financial service providers under their jurisdictions.[2] These commenters noted their interest in addressing the potential for inconsistent regulatory treatment of lenders based on whether or not they are supervised solely by state agencies. Subsequently, the CSBS, along with a national organization representing state residential mortgage regulators, issued a press release confirming their intent to offer guidance to state regulators to apply to their licensed residential mortgage brokers and lenders.[3]

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[1] Nine of these letters requested a thirty-day extension of the comment period, which the Agencies granted.

[2] Letter to J. Johnson, Board Secretary, *et al.* from N. Milner, President & CEO, Conference of State Bank Supervisors (Feb. 14, 2006); Letter to J. Johnson, Board Secretary, *et al.*, from B. Kent, Chair, State Financial Regulators Roundtable.

[3] Media Release, CSBS & American Association of Residential Mortgage Regulators, "CSBS and AARMR Consider Guidance on Nontraditional Mortgage Products for State-Licensed Entities" (June 7, 2006), *available at*
http://www.csbs.org/Content/NavigationMenu/PublicRelations/PressReleases/News_Releases.htm. The press release stated:

> The guidance being developed by CSBS and AARMR is based upon proposed guidance issued in December 2005 by the Office of the Comptroller of the Currency, the Board of

II. Final Joint Guidance

The Agencies made a number of changes to the proposal to respond to commenters' concerns and to provide additional clarity. Significant comments on the specific provisions of the proposed guidance, the Agencies' responses, and changes to the proposed guidance are discussed as follows.

Scope of the Guidance

Many financial institution and trade group commenters raised concerns that the proposed guidance did not adequately define "nontraditional mortgage products." They requested clarification of which products would be subject to enhanced scrutiny. Some suggested that the guidance focus on products that allow negative amortization, rather than interest-only loans. Others suggested excluding certain products with nontraditional features, such as reverse mortgages and home equity lines of credit (HELOCs). Those commenting on interest-only loans noted that they do not present the same risks as products that allow for negative amortization. Those that argued that HELOCs should be excluded noted that they are already covered by interagency guidance issued in 2005. They also noted that the principal amount of these loans is generally lower than that for first mortgages. As for reverse mortgages, the commenters pointed out that they were developed for a specific market segment and do not present the same concerns as products mentioned in the guidance.

To address these concerns, the Agencies are clarifying the types of products covered by the guidance. In general, the guidance applies to all residential mortgage loan products that allow borrowers to defer repayment of principal or interest. This includes all interest-only products and negative amortization mortgages, with the exception of HELOCs. The Agencies decided not to include HELOCs in this guidance, other than as discussed in the Simultaneous Second-Lien Loans section, since they are already covered by the May 2005 Interagency Credit Risk Management Guidance for Home Equity Lending. The Agencies are amending the May 2005 guidance, however, to address the consumer disclosure recommendations included in the nontraditional mortgage guidance.

The Agencies decided against focusing solely on negative amortization products. Many of the interest-only products pose risks similar to products that allow negative amortization, especially when combined with high leverage and reduced documentation. Accordingly, they present similar concerns from a risk management and consumer

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Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

The federal guidance, when finalized, will only apply to insured financial institutions and their affiliates. CSBS and AARMR intend to develop a modified version of the guidance which will primarily focus on residential mortgage underwriting and consumer protection. The guidance will be offered to state regulators to apply to their licensed residential mortgage brokers and lenders.

protection standpoint. The Agencies did, however, agree that reverse mortgages do not present the types of concerns that are addressed in the guidance and should be excluded.

Loan Terms and Underwriting Standards

Qualifying Borrowers

The Agencies proposed that for all nontraditional mortgage products, the analysis of borrowers' repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule. In addition, the proposed guidance stated that for products that permit negative amortization, the repayment analysis should include the initial loan amount plus any balance increase that may accrue from negative amortization. The amount of the balance increase is tied to the initial terms of the loan and estimated assuming the borrower makes only the minimum payment.

Generally, banks and industry groups believed that the proposed underwriting standards were too prescriptive and asked for more flexibility. Consumer groups generally supported the proposed underwriting standards, warning that deteriorating underwriting standards are bad for individual borrowers and poor public policy.

A number of commenters suggested that industry practice is to underwrite payment option adjustable-rate mortgages at the fully indexed rate, assuming a fully amortizing payment. Yet several commenters argued that this standard should not be required when risks are adequately mitigated. Moreover, many commenters opposed assuming a fully amortizing payment for interest-only loans with extended interest-only periods. They argued that the average life span of most mortgage loans makes it unlikely that many borrowers will experience the higher payments associated with amortization. Additionally, many commenters opposed the assumption of minimum payments during the deferral period for products that permit negative amortization on the ground that this assumption suggests that lenders assume a worst-case scenario.

The Agencies believe that institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the full amount of credit that may be extended. That analysis should consider both principal and interest at the fully indexed rate. Using discounted payments in the qualification process limits the ability of borrowers to demonstrate sufficient capacity to repay under the terms of the loan. Therefore, the proposed general guideline of qualifying borrowers at the fully indexed rate, assuming a fully amortizing payment, including potential negative amortization amounts, remains in the final guidance.

Regarding interest-only loans with extended interest-only periods, the Agencies note that since the average life of a mortgage is a function of the housing market and interest rates, the average may fluctuate over time. Additionally, the Agencies were concerned that excluding these loans from the underwriting standards could cause some creditors to change their market offerings to avoid application of the guidance. Accordingly, the final guidance does not exclude interest-only loans with extended interest-only periods.

Finally, regarding the assumption for the amount that the balance may increase due to negative amortization, the Agencies have revised the language to respond to commenters' requests for clarity. The basic standard, however, remains unchanged. The

Agencies expect a borrower to demonstrate the capacity to repay the full loan amount that may be advanced.[4] This includes the initial loan amount plus any balance increase that may accrue from the negative amortization provision. The final document contains guidance on determining the amount of any balance increase that may accrue from the negative amortization provision, which does not necessarily equate to the full negative amortization cap for a particular loan.

The Agencies requested comment on whether the guidance should address consideration of future income or other future events in the qualification standards. The commenters generally agreed that there is no reliable method for considering future income or other future events in the underwriting process. Accordingly, the Agencies have not modified the guidance to address these issues.

Collateral-Dependent Loans

Commenters that specifically addressed this aspect of the guidance concurred that it is unsafe and unsound to rely solely on an individual borrower's ability to sell or refinance once amortization commences. However, many expressed concern about the possibility that the term "collateral-dependent," as it is used in the guidance, would be interpreted to apply to stated income and other reduced documentation loans.

To address this concern, the Agencies provided clarifying language in a footnote to this section. The final guidance provides that a loan will not be determined to be collateral-dependent solely because it was underwritten using reduced documentation.

Risk Layering

Financial institution and industry group commenters were generally critical of the risk layering provisions of the proposed guidance on the grounds that they were too prescriptive. These commenters argued that institutions should have flexibility in determining factors that mitigate additional risks presented by features such as reduced documentation and simultaneous second-lien loans. A number of commenters, however, including community and consumer organizations, financial institutions, and industry associations, suggested that reduced documentation loans should not be offered to subprime borrowers. Others questioned whether stated income loans are appropriate under any circumstances, when used with nontraditional mortgage products, or when used for wage earners who can readily provide standard documentation of their wages. Several commenters argued that simultaneous second-lien loans should be paired with nontraditional mortgage loans only when borrowers will continue to have substantial equity in the property.

The Agencies believe that the guidance provides adequate flexibility in the methods and approaches to mitigating risk, with respect to risk layering. While the Agencies have not prohibited any of the practices discussed, the guidance uniformly suggests strong quality control and risk mitigation factors with respect to these practices.

The Agencies declined to provide guidance recommending reduced documentation loans be limited to any particular set of circumstances. The final guidance recognizes that mitigating factors may determine whether such loans are appropriate, but

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[4] This is similar to the standard in the Agencies' May 2005 Credit Risk Management Guidance for Home Equity Lending recommending that, for interest-only and variable rate HELOCs, borrowers should demonstrate the ability to amortize the fully drawn line over the loan term.

reminds institutions that a credible analysis of both a borrower's willingness and ability to repay is consistent with sound and prudent lending practices. The final guidance also cautions that institutions generally should be able to readily document income for wage earners through means such as W-2 statements, pay stubs, or tax returns.

Portfolio and Risk Management Practices

Many financial institution and industry group commenters opposed provisions of the proposed guidance for the setting of concentration limits. Some commenters advocated active monitoring of concentrations or diversification strategies as more appropriate approaches. The intent of the guidance was not to set hard concentration limits for nontraditional mortgage products. Instead, institutions with concentrations in these products should have well-developed monitoring systems and risk management practices. The guidance was clarified to reiterate this point.

Additionally, a number of financial institution and industry association commenters opposed the provisions regarding third-party originations. They argued that the proposal would force lenders to have an awareness and control over third-party practices that is neither realistic nor practical. In particular, many of these commenters argued that lenders should not be responsible for overseeing the marketing and borrower disclosure practices of third parties.

Regarding controls over third-party practices, the Agencies clarified their expectations that institutions should have strong systems and controls for establishing and maintaining relationships with third parties. Reliance on third-party relationships can significantly increase an institution's risk profile. The guidance, therefore, emphasizes the need for institutions to exercise appropriate due diligence prior to entering into a third-party relationship and to provide ongoing, effective oversight and controls. In practice, an institution's risk management system should reflect the complexity of its third-party activities and the overall level of risk involved.

A number of commenters urged the Agencies to remove language in the proposed guidance relating to implicit recourse for loans sold in the secondary market. They expressed concern that the proposal added new capital requirements. The Agencies clarified the language in the guidance addressing this issue. The Agencies do not intend to establish new capital requirements. Instead, the Agencies' intent is to reiterate existing guidelines regarding implicit recourse under the Agencies' risk-based capital rules.

Consumer Protection Issues

Communications with Consumers

Many financial institution and trade group commenters suggested that the Agencies' consumer protection goals would be better accomplished through generally applicable regulations, such as Regulation Z (Truth in Lending)[5] or Regulation X (Real Estate Settlement Procedures).[6] Some commenters stated that the proposed guidance

[5] 12 CFR Part 226 (2006).
[6] 24 CFR Part 3500 (2005).

would add burdensome new disclosure requirements and cause a confusing overlap with current Regulation Z requirements. They also expressed concern that the guidance would contribute to an overload of information currently provided to consumers. Additionally, some argued that implementing the disclosure provisions might trigger Regulation Z requirements concerning advertising.[7] Some commenters also urged the Agencies to adopt model disclosure forms or other descriptive materials to assist in compliance with the guidance.

Some commenters voiced concern that the Agencies are attempting to establish a suitability standard similar to that used in the securities context. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves.

Finally, several community and consumer organization commenters questioned whether additional disclosures are sufficient to protect borrowers and suggested various additional measures, such as consumer education and counseling.

The Agencies carefully considered the commenters' argument that consumer protection issues – particularly, disclosures – would be better addressed through generally applicable regulations. The Agencies determined, however, that given the growth in this market, guidelines are needed now to ensure that consumers will receive the information they need about the material features of nontraditional mortgages as soon as possible.

The Agencies also gave careful consideration to the commenters' concerns that the guidelines will overlap with Regulation Z, add to the disclosure burden on lenders, and contribute to information overload. While the Agencies are sensitive to these concerns, we do not believe they warrant significant changes to the guidance. The guidance focuses on providing information to consumers during the pre-application shopping phase and post-closing with any monthly statements lenders choose to provide to consumers. Moreover, the Agencies do not anticipate that the information outlined in the guidance will result in additional lengthy disclosures. Rather, the Agencies contemplate that the information can be provided in brief narrative format and through the use of examples based on hypothetical loan transactions.[8] We have, however, revised the guidance to make clear that transaction-specific disclosures are not required. Institutions will still need to ensure that their marketing materials promoting their products comply with Regulation Z, as applicable.

As previously discussed, some commenters, including industry trade associations, asked the Agencies to include model or sample disclosures or other descriptive materials as part of the guidance to assist lenders, including smaller institutions, in following the recommended practices for communications with consumers. The Agencies have determined not to include required model or sample disclosures in the guidance. Instead, the guidance provides a set of recommended practices to assist institutions in addressing particular risks raised by nontraditional mortgage products.

The Agencies have determined that it is desirable to first seek public comment on potential model disclosures, and in a Federal Register notice accompanying this guidance are seeking comment on proposed illustrations of consumer information for

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[7] See 12 CFR Part 226.24(c) (2006).
[8] See ____ FR ____________ (date) (Proposed Illustrations of Consumer Information for Nontraditional Mortgage Products).

nontraditional mortgage products that are consistent with the recommendations contained in the guidance. The Agencies appreciate that some institutions, including community banks, following the recommendations set forth in the guidance may prefer not to incur the costs and other burdens of developing their own consumer information documents. The Agencies are, therefore, requesting comment on illustrations of the type of information contemplated by the guidance.

The Agencies disagree with the commenters who expressed concern that the guidance appears to establish a suitability standard, under which lenders would be required to assist borrowers in choosing products that are suitable to their needs and circumstances. It was not the Agencies' intent to impose such a standard, nor is there any language in the guidance that does so. In any event, the Agencies have revised certain statements in the proposed guidance that could have been interpreted to suggest a requirement to ensure that borrowers select products appropriate to their circumstances.

Control Systems

Several commenters requested more flexibility in designing appropriate control systems. The Agencies have revised the "Control Systems" portion of the guidance to clarify that we are not requiring any particular means of monitoring adherence to an institution's policies, such as call monitoring or mystery shopping. Additional changes have also been made to clarify that the Agencies do not expect institutions to assume an unwarranted level of responsibility for the actions of third parties. Rather, the control systems that are expected for loans purchased from or originated through third parties are consistent with the Agencies' current supervisory policies. As previously discussed, the Agencies have also made changes to the portfolio and risk management practices portion of the final guidance to clarify their expectations concerning oversight and monitoring of third-party originations.

IV. Text of Final Joint Guidance

The text of the final Interagency Guidance on Nontraditional Mortgage Product Risks follows:

Interagency Guidance on Nontraditional Mortgage Product Risks

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "payment option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.[1]

[1] Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements ("reduced documentation") and are increasingly combined with simultaneous second-lien loans.[2] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) expect institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[3]

Institutions should use this guidance to ensure that risk management practices adequately address these risks. The Agencies will carefully scrutinize risk management processes, policies, and procedures in this area. Institutions that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

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loans. This guidance does not apply to reverse mortgages; home equity lines of credit ("HELOCs"), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

[2] Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

[3] Refer to Interagency Guidelines Establishing Standards for Safety and Soundness. For each Agency, those respective guidelines are addressed in: 12 CFR Part 30 Appendix A (OCC); 12 CFR Part 208 Appendix D-1 (Board); 12 CFR Part 364 Appendix A (FDIC); 12 CFR Part 570 Appendix A (OTS); and 12 U.S.C. 1786 (NCUA).

LOAN TERMS AND UNDERWRITING STANDARDS

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the agencies' real estate lending standards and appraisal regulations and associated guidelines.[4]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualifying Borrowers – Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,[5] assuming a fully amortizing repayment

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[4] Refer to 12 CFR Part 34 - Real Estate Lending and Appraisals, OCC Bulletin 2005-3 – Standards for National Banks' Residential Mortgage Lending, AL 2003-7 – Guidelines for Real Estate Lending Policies and AL 2003-9 – Independent Appraisal and Evaluation Functions (OCC); 12 CFR 208.51 subpart E and Appendix C and 12 CFR Part 225 subpart G (Board); 12 CFR Part 365 and Appendix A, and 12 CFR Part 323 (FDIC); 12 CFR 560.101 and Appendix and 12 CFR Part 564 (OTS). Also, refer to the 1999 Interagency Guidance on the "Treatment of High LTV Residential Real Estate Loans" and the 1994 "Interagency Appraisal and Evaluation Guidelines." Federally Insured Credit Unions should refer to 12 CFR Part 722 - Appraisals and NCUA 03-CU-17 – Appraisal and Evaluation Functions for Real Estate Related Transactions (NCUA).

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the

schedule.[6] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[7]

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans – Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[8] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering – Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation – Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be

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number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

[6] The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

[7] The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

[8] A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans – Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

Introductory Interest Rates – Many institutions offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

Lending to Subprime Borrowers – Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime lending.[9] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

Non-Owner-Occupied Investor Loans – Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the

[9] Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Programs, January 31, 2001. Federally insured credit unions should refer to 04-CU-12 – Specialized Lending Activities (NCUA).

possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.[10]

PORTFOLIO AND RISK MANAGEMENT PRACTICES

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should:

- Develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Design enhanced performance measures and management reporting that provide early warning for increasing risk;
- Establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- Maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Policies – An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations – Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Monitoring should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as loans with high combined LTV ratios, loans with high DTI ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, loans with risk-layered features, and non-owner-occupied investor loans. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

[10] Federally insured credit unions must comply with 12 CFR Part 723 for loans meeting the definition of member business loans.

Controls – An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.
Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third-Party Originations – Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.[11]

Secondary Market Activity – The sophistication of an institution's secondary market risk management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary market activities should have comprehensive, formal strategies for managing risks.[12] Contingency planning should include how the institution will respond to reduced demand in the secondary market.

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[11] Refer to OCC Bulletin 2001-47 – Third-Party Relationships and AL 2000-9 – Third-Party Risk (OCC). Federally insured credit unions should refer to 01-CU-20 (NCUA), Due Diligence over Third Party Service Providers. Savings associations should refer to OTS Thrift Bulletin 82a – Third Party Arrangements.

[12] Refer to "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," May 23, 2002; OCC Bulletin 2002-22 (OCC); SR letter 02-16 (Board); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, November 1997. See OTS Examination Handbook Section 221, Asset-Backed Securitization. The Board also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21. Federally insured credit unions should refer to 12 CFR Part 702 (NCUA).

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the agencies' view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is implicit recourse. Under the agencies' risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.[13] Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

Management Information and Reporting – Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by loan type (e.g., interest-only mortgage loans and payment option ARMs); by risk-layering features (e.g., payment option ARM with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); by underwriting characteristics (e.g., LTV, DTI, and credit score); and by borrower performance (e.g., payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk tolerance levels.

Stress Testing – Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring and managing risk, as well as developing appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

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[13] Refer to 12 CFR Part 3 Appendix A, Section 4 (OCC); 12 CFR Parts 208 and 225, Appendix A, III.B.3 (FRB); 12 CFR Part 325, Appendix A, II.B (FDIC); 12 CFR 567 (OTS); and 12 CFR Part 702 (NCUA) for each Agency's capital treatment of recourse.

Capital and Allowance for Loan and Lease Losses – Institutions should establish an appropriate allowance for loan and lease losses (ALLL) for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. In accordance with interagency guidance, the valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

CONSUMER PROTECTION ISSUES

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner – before disclosures may be required under the Truth in Lending Act or other laws – to assist the consumer in the product selection process.

[14] Refer to the "Interagency Advisory on Mortgage Banking," February 25, 2003, issued by the bank and thrift regulatory agencies. Federally Insured Credit Unions with assets of $10 million or more are reminded they must report and value nontraditional mortgages and related mortgage servicing rights, if any, consistent with generally accepted accounting principles in the Call Reports they file with the NCUA Board.

Concerns and Objectives – More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

Legal Risks – Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages in advertisements, with an application,[15] before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

[15] These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

[16] The OCC, the Board, and the FDIC enforce this provision under the FTC Act and section 8 of the FDI Act. Each of these agencies has also issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. *See* OCC Advisory Letter 2002-3 - Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. Federally insured credit unions are prohibited from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition. 12 CFR 740.2. The OTS also has a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered. 12 CFR 563.27. This regulation supplements its authority under the FTC Act.

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Agencies note that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

Communications with Consumers – When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when a consumer is shopping for a mortgage – such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products, or when marketing relating to nontraditional mortgage products is provided by the institution to the consumer – not just upon the submission of an application or at consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.[19]

Promotional Materials and Product Descriptions. Promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

- Payment Shock. Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product

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[17] Institutions also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

[18] Institutions also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

[19] Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

- Negative Amortization. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home).
- Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.[21]
- Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

Monthly Statements on Payment Option ARMs. Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid. Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that

[20] Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

[21] Federal credit unions are prohibited from imposing prepayment penalties. 12 CFR 701.21(c)(6).

these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[22] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

Control Systems – Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

[22] For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

<u>APPENDIX</u>: Terms Used in this Document

Interest-only Mortgage Loan – A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM – A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation – A loan feature that is commonly referred to as “low doc/no doc,” “no income/no asset,” “stated income” or “stated assets.” For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.

Simultaneous Second-Lien Loan – A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

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GENERAL BUSINESS

January 18, 2007

Memorandum To: Interested Member Bank Representatives

Re: FinCEN Publishes Its Report To Congress on the Feasibility of a Cross-Border Electronic Funds Transfer Reporting System

FinCEN announced yesterday publication of its long-awaited report to Congress on the feasibility of implementing a cross-border wire transfer reporting system. The report was mandated under the Intelligence Reform and Terrorism Prevention Act of 2004 (IRTPA) and is the product of extensive consultation by FinCEN with other government agencies and various industry representatives over the last two years. The Institute and a number of member institutions have played an active role in this process, and the report to Congress reflects several of our specific suggestions, but not our overall recommendation against such reporting. The full report is available on the FinCEN web site at www.fincen.gov/cross_border/CBFTFS_Complete.pdf.

The report concludes that establishing a cross-border wire transfer reporting system "is technically feasible" and "may be valuable" to the ongoing efforts to combat money laundering and terrorist financing. FinCEN has determined that the basic information already obtained and maintained by financial institutions under the Bank Secrecy Act provides a "sufficient basis for meaningful data analysis." In addition, FinCEN has accepted the position urged by the Institute, interested member institutions and others that any reporting requirement should apply on a "first in/first out" basis, so that reporting would be limited "only to those U.S. "gatekeeper" institutions that exchange payment instructions directly with foreign institutions." FinCEN has further determined that a $3,000 reporting threshold should apply, measured on the basis of discrete transactions (as opposed to aggregating multiple transactions of less than $3,000 that may be conducted very close in time to each other).

Significantly, the report does not draw any final, definitive conclusion on whether to implement such a requirement and instead calls for an incremental, step-by-step approach to determining whether and how to implement a regulatory requirement for the reporting of cross-border wire transfer data. As described in the report, FinCEN plans to "create a development plan that incorporates a series of milestones and would permit pilot testing of different aspects" along the way, thereby enabling the establishment of a system in manageable stages, with testing of the system's functionality at each stage before moving on to the next. Of particular note, the report states that this approach "provides the opportunity to alter or halt the effort before FinCEN or the U.S. financial services industry incurs significant costs."

FinCEN has adopted this incremental development and implementation process in recognition that there are still a number of significant technical and policy issues that remain to be resolved. **In addition to the costs to both financial institutions and the government, and continuing questions regarding the government's ability to use the reported data effectively, the report highlights concerns regarding the potential effect that imposition of a reporting requirement could have on U.S. dollar-based payment systems such as (i) a shift away from the U.S. dollar as the basis for international financial transactions, (ii) the creation of mechanisms and facilities for clearing U.S. dollars outside the United States, and (iii) interference with the operation of central payment systems.** Moreover, the report acknowledges the prospect that "as-yet unidentified issues" might arise which could impede the project or cause it to be unfeasible.

As described in the report, FinCEN plans to devote the next year to studying and resolving the remaining issues, and it is contemplated that the project as a whole, if brought to a successful conclusion, would require a total of approximately three and one-half years further effort. Moreover, and as required by IRTPA, regulations would have to be adopted to implement a reporting system, which in turn would require a formal notice-and-comment rulemaking process. As a first step, FinCEN will undertake further consultations with the law enforcement, regulatory and intelligence communities regarding the possible uses to which reported information might be put. At the same time, FinCEN will consult further with the financial services industry and others to quantify more precisely the costs and burdens associated with imposing a reporting requirement.

Going forward, the Institute will continue to play an active role in this process with a view to minimizing the costs and burdens to member institutions of any resulting reporting requirement.

Please contact the undersigned or Richard Coffman if you have any questions or require any further information.

Lawrence R. Uhlick
Chief Executive Officer

cc: Board of Trustees
National and Regional Banking Associations
Committees

GOODWIN | PROCTER

January 4, 2007

Environmental & Energy Advisory

An update on law, policy and strategy

Climate Change Strategies for the Financial Services Industry

"The breaking news is the arrival of a new set of stakeholders on the environmental scene, including banks and insurance companies. When the financial services industry – which focuses like a laser on return on investment – starts to worry about the environment, you know something big is happening." [1]

Concerns about climate change have entered the mainstream of America's media. Major magazines, such as *Vanity Fair*, *Time* and *Fortune*, have printed feature stories about climate change and other environmental issues, and Al Gore's movie, "An Inconvenient Truth," has been a box office success. Other publications highlight the monetary upsides available in connection with addressing environmental issues. For instance, the July 2006 edition of *Wired* listed green and clean technologies as one of the six trends driving the global economy. In the face of such widespread media coverage, businesses, including members of the lending community, can no longer ignore the concerns, risks and potential opportunities associated with climate change.

Although the banking community has not yet been a primary focus of advocacy groups or shareholder suits demanding greater activity in response to climate change, banks are not immune from the effects of growing public and regulatory concern regarding global warming, particularly efforts to reduce the emissions of carbon dioxide ("CO_2") and other greenhouse gases ("GHG"). There is increasing stakeholder pressure for banks and other members of the financial services industry to acknowledge and address climate change as a major issue and its potential effects on their businesses and those of their customers. Indeed, as a major source of capital for industrial development and operations, lenders are uniquely positioned to have a significant impact on addressing climate change.

Banks can address climate change issues from several perspectives. First, lending institutions can adopt the same strategies used in other business sectors to measure and reduce their own direct and indirect CO_2 emissions. Second, they can incorporate consideration of climate change issues into their lending policies. Finally, financial institutions may find opportunities in investing in climate-related projects or in focusing on customers producing "clean technologies" that reduce GHG emissions. This advisory

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[1] Daniel C. Esty and Andrew S. Winston, *Green to Gold: How Smart Companies Use Environmental Strategy to Innovate, Create Value, and Build Competitive Advantage*, New Haven (2006), pg. 9.

will review recent developments that have led to increasing pressure for the business community to address global warming, examine steps that banks have taken to date and suggest potential strategies that banks and other financial services companies can implement to address the business risks and opportunities associated with climate change.

Why Does Climate Change Matter?

The combustion of carbon-containing fossil fuels, such as oil, natural gas and coal, over the last 150 years has significantly increased atmospheric concentrations of CO_2 and other GHGs. Scientists predict that heat trapped by atmospheric GHGs contributes to rising temperatures, droughts, melting glaciers, increasing severity of natural weather events such as hurricanes, rising sea levels and the spread of non-native species. Such changes may adversely affect human health (*e.g.*, spreading tropical diseases), agriculture (*e.g.*, irrigation demands and crop yields), water resources (*e.g.*, supply and quality), coastal areas (*e.g.*, erosion of beaches and damage to coastal communities), species (*e.g.*, loss of habitats, reduced ocean productivity), with resulting adverse economic impacts across broad sectors of the economy.

The news media have recently reported on numerous scientific and economic studies regarding the impacts and risks of climate change. Recent examples include:

- *The Stern Review on the Economics of Climate Change* (Oct. 2006): Projected that an investment equivalent to 1% of the world's annual economic output by 2050 in methods to cut GHG emissions is necessary to avoid environmental costs of global warming ranging between 5% to 20% of the world's gross domestic product after 2050.

- *National Center for Atmospheric Research Report* (Dec. 2006): Projected that global warming caused by the emission of greenhouse gases is contributing to the accelerated melting of sea ice in the Arctic Ocean, which could disappear by 2040. Also in December 2006, the U.S. Department of the Interior proposed to list the polar bear as a threatened species based on the predicted disappearance of its sea ice habitat.

- *U.S. Energy Information Administration ("EIA")* (Dec. 2006): Predicted that CO_2 emissions from American energy use alone will increase 1.2% per year through 2030, reflecting that voluntary efforts to-date to control CO_2 emissions may not be sufficient. The EIA also reported in 2006 that China's CO_2 emissions are projected to exceed those in the United States as early as 2009.

Although such studies have critics and skeptics, many governments and businesses have decided it is necessary to address GHG emissions without waiting for further scientific evidence or mandatory regulation. Thus, it may be increasingly difficult for companies to rely on scientific uncertainty as a rationale for not considering the impact of or reducing their GHG emissions. GE's CEO Jeff Immelt may have summarized it best, "[w]e are in a carbon-constrained world *now*."

What Is Being Done in the United States to Address GHG Emissions?

Unlike in Europe and most of the rest of the industrialized world, in which the Kyoto Protocol requires mandatory GHG emission reductions, GHG emissions remain largely unregulated in the United States. Some American businesses have been participating in voluntary programs sponsored by governmental authorities and non-profit organizations to track, report and reduce their GHG emissions. *See* Goodwin Procter's April 1, 2004 *Environmental Law Advisory*, "Greenhouse Gas Management Strategies for U.S. Corporations," for a discussion of several of these initiatives, such as the EPA Climate Leaders program and the Chicago Climate Exchange. For instance, over 40 companies are participating in EPA's Fortune 500 Green Power Challenge, which, in December 2006, challenged Fortune 500 companies to roughly double their current level of green power purchasing.

Mandatory regulation of GHGs in the United States is limited, existing primarily at the state level and largely confined to power generation facilities and automobiles. For instance, Massachusetts, Wisconsin, Oregon and New Hampshire have adopted rules that require some form of reductions or offsets of CO_2 emissions from existing or new power plants. Ten states have adopted or will adopt California's stringent GHG emission standards for motor vehicles, which have been challenged in pending litigation. Nearly 200 municipalities have pledged to adopt the Kyoto Protocol targets for reducing their greenhouse gas emissions.

Several recent developments suggest that broader regional and federal mandatory GHG regulations are likely within the next few years. For example, states in New England and the Mid-Atlantic region are developing a precedent-setting program to regulate GHG emissions: a regional cap-and-trade program known as the Regional Greenhouse Gas Initiative (RGGI). RGGI, scheduled to take effect on January 1, 2009, currently involves seven states (with more likely to join) and will initially limit CO_2 emissions from fossil-fuel power plants. On September 27, 2006, California enacted legislation, AB 32, to regulate GHG emissions not only from power plants, but also from any "significant" sources of emissions. At the federal level, several senators, including Senators Boxer (D-CA), Lieberman (D-CT), McCain (R-AZ), Bingaman (D-NM), Kerry (D-MA) and Feinstein (D-CA), are expected to introduce or re-introduce legislation to mandate regulation of GHGs. Last year, the Senate passed a non-binding bipartisan resolution calling for mandatory market-based limits on GHG emissions.

Climate change-related litigation appears to be on the rise. The U.S. Supreme Court is currently considering whether the federal Environmental Protection Agency ("EPA") has authority to regulate CO_2 as a "pollutant" under the Clean Air Act. The case, *Massachusetts et. al. v. EPA*, raises the question of EPA's authority in the context of motor vehicle emissions. A similar case in the D.C. Circuit Court of Appeals, *Coke Oven Environmental Task Force, et. al. v. EPA*, involves EPA's authority to regulate CO_2 emissions from new electricity generators. Thus, it is possible that, within the next six months, the courts will rule that the EPA has the authority to regulate emissions related to climate change and therefore must evaluate whether specific regulations are necessary and, if so, develop and implement such requirements.

Plaintiffs in several pending tort suits are seeking various forms of relief against corporate defendants under nuisance and negligence theories for climate-related injuries allegedly caused by the defendants' GHG emissions. These include *Connecticut, et al. v. American Electric Power, et al*. (seeking an injunction requiring five utilities to reduce their CO_2 emissions); *Comer, et al. v. Murphy Oil, et al*. (seeking damages from oil, coal, electric power and chemical company defendants for destruction by Hurricane Katrina allegedly caused by defendants' CO_2 emissions); and *California v. General*

Motors, et al. (seeking damages from six auto manufacturers for public nuisance injuries allegedly caused by automotive CO_2 emissions). While the outcome of these cases is uncertain, climate-related litigation presents a risk to carbon-intensive industries.

Climate Risks to Lenders

While not widely appreciated, lenders and their clients face a number of risks relating to climate change. A key risk and uncertainty for borrowers in carbon-intensive industries is the regulation of GHG emissions and the associated costs of controls or emission offset credit purchases. Companies in the electric power and auto industries may also be vulnerable to climate-related litigation. Another category of risks to borrowers' (and banks') operations are those associated with extreme weather events potentially caused by climate change and resulting in property damage and business disruption. Some industry sectors, such as agriculture, forestry, food, building supplies, construction, tourism and insurance, are particularly sensitive to the effects of drought, flooding and storms.

Other types of climate-related risk that may affect lenders and other financial services companies are reputational and competitive risks based on these institutions' response to climate change issues. Non-governmental organizations (NGOs) such as CERES and the related group of institutional investor groups and the Investor Network on Climate Risk (representing nearly $4 trillion of assets), are bringing increased pressure for corporate action on climate change issues, including greater disclosure and corporate governance focus on business risks and opportunities posed by climate change. While these groups have to date focused primarily on carbon-intensive industries, their focus is beginning to include financial institutions. Banks and other financial institutions that do not have credible policies and programs addressing climate change may fare poorly in reviews by these and other climate-focused advocacy groups, and may also be at risk of major institutional investors taking their money elsewhere. Similarly, when some banks and other financial services companies commit to take action on climate issues, it creates competitive pressure to act and may result in potential competitive disadvantage in the eyes of customers and investors and for those that fail to address this issue. These risks and pressures are likely to increase as awareness of climate change and its impact becomes more widespread.

Climate Opportunities for Financial Institutions

Several major U.S. banks are taking action to address their own GHG emissions, and in some cases those of their customers through their lending policies and investment decisions.

Internal Actions

Members of the lending community have already begun to adopt climate change policies in which the institution agrees to measure, report and reduce its own energy consumption and CO_2 emissions. For example, Bank of America set a goal to reduce its GHG emissions by 7% by 2008. Wachovia similarly states in its climate change policy that it will reduce its absolute CO_2 emissions by 10% from 2005 levels by 2010. Citigroup set its goal of a 10% reduction of its GHG emission by 2011. Some banks have also elected to participate in voluntary GHG reduction programs. Wells Fargo is participating in EPA's Fortune 500 Green Power Challenge and reports purchasing 550 million kilowatt hours of green power, or 42% of the company's total electricity use, primarily through the purchase of wind power renewable energy credits.

Reducing internal GHG emissions can take many forms, ranging from replacing company vehicles with hybrid-powered cars to purchasing non-emitting "green" power to improving the efficiency of heating and cooling systems to motivating employees to use public transportation. Like any other property-owner, banks should also consider green building designs – which minimize emissions, limit waste and reduce utility use – when constructing new offices or renovating existing ones. Some municipalities (*e.g.*, Boston) are beginning to require the incorporation of green design considerations into new buildings, with a few even providing an expedited permitting process for buildings that meet such requirements.

Lending Policies

Lending institutions' existing credit underwriting criteria may already include some consideration of environmental issues, such as contaminated real estate and compliance with environmental laws. For instance, over 40 major financial institutions have voluntarily adopted the Equator Principles, a program that requires an environmental assessment for any project financing, regardless of location or industry, with total capital costs of $10 million or more.

Banks may also wish to consider whether the projected impacts of climate change, including the greater likelihood of severe hurricanes or additional regulatory requirements, may affect the risk of a particular loan. The need for such an analysis will likely differ depending on factors such as the geographic location of a borrower's assets (*e.g.*, in a coastal area or hurricane path), and the industry sector to which a loan is being made (*e.g.*, investments in new energy facilities).

Although some of the risks of climate change are more likely to occur after the term of many current loans has expired, some banks are already developing tools to evaluate the climate change risk of their existing and potential clients and providing resources for their clients to reduce their impact on climate change. For example, JPMorgan Chase has committed to encouraging clients that are large GHG emitters to develop carbon mitigation plans, adding carbon disclosure and mitigation to its client review process, quantifying the cost of GHG emissions for transactions in the power sector and integrating this factor into the financial analysis of the transaction. Thus, banks can work with their clients to identify and mitigate the GHG emissions and climate-related risks associated with specific projects.

Non-profit entities are also working to influence banks' approach to climate change. For example, in November 2006, BankTrack, an international coalition focused on commercial financial institutions, published a report entitled "The Dos and Don'ts of Sustainable Banking," which calls upon financial institutions to endorse six commitments to sustainable business practices. The World Wildlife Fund and BankTrack also recently published a report entitled "Shaping the Future of Sustainable Finance: Moving the Banking Sector From Promises to Performance," which evaluates how commercial and investment banks are addressing certain environmental and social issues, including climate change. The Rainforest Action Network ("RAN"), an activist NGO, has a global finance campaign aimed at removing financing from projects that negatively impact the environment. One of RAN's goals is to persuade other banks to join Citigroup, Goldman Sachs and JPMorgan Chase in adopting policies that protect old growth and endangered forests, stop investments in projects that exacerbate climate change and protect indigenous peoples.

Investments and New Business Opportunities

There is a growing international trend of “green” investment in renewable energy, clean technologies and other products and services that contribute to the reduction of GHG emissions. For instance, Morgan Stanley recently announced that it will dedicate approximately $3 billion to buying carbon credits and investing in low-emitting energy projects. Goldman Sachs has committed to dedicate up to $1 billion for investment in renewable energy and energy efficiency projects. Lehman, Fortis, BNP Paribas and others recently purchased $263 million worth of carbon credits from a Chinese mining company. Numerous venture capital and private equity funds are investing in companies developing “clean” environmental and renewable energy technologies. As *The Economist* noted in its November 18, 2006, edition, “[i]nvestors are falling over themselves to finance start-ups in clean technology, especially in energy.”

Another potential business opportunity for the financial sector with respect to climate change relates to the expanding international and domestic markets for GHG emission reduction credits. A recent report by the World Bank found that the market for trading CO_2 emission allowances was approximately $21 billion during the first three quarters of 2006. While the European Union (“EU”) Emissions Trading Scheme accounted for the bulk of these transactions (almost $19 billion), the Chicago Climate Exchange, the first voluntary and legally binding GHG emission reduction and trading system in America, already accounts for 21% of the market for trading CO_2 emission allowances, equaling approximately $27 million in value. Also, in November 2006, UBS introduced the world’s first index of global GHG allowances. Although the UBS index will initially cover only EU emissions trading schemes, the bank has not ruled out the possibility of expanding the index to additional markets in the future.

Conclusion

The financial services industry has an important stake in responding to climate change. Climate change issues present both risks and potential opportunities for lenders and other financial institutions. In evaluating whether and how to address climate change issues, banks should consider both financial and intangible costs and benefits, such as those relating to reputation and competitive position. Increasingly, the public’s perception of a company’s environmental policy, including its stance on climate change, can impact the company’s market position, especially if it is perceived as being either ahead of or behind its peer companies. The non-profit organizations that advocate for voluntary environmental commitments by businesses can be both helpful as partners and harmful as adversaries.

To address these risks, financial institutions should consider the following strategic steps:

- Develop and implement a climate change policy to address internal actions and decision-making, including measuring and reducing direct and indirect CO_2 emissions.

- Incorporate climate change considerations into lending policies, for example, by:

- identifying and assessing industries likely to be subject to regulatory requirements or clients more likely to be affected by extreme weather events potentially caused by climate change;
- developing climate change-related due diligence policies for sectors with greater direct GHG emissions, such as energy, utilities, automotive and extractive industries; and
- quantifying the cost of GHG emissions of a potential client and incorporating this factor into financial analysis.

- Partner with reputable NGOs that focus on climate change in developing internal or lending climate change policies.
- Develop tools to facilitate clients' assessment of their own risks associated with climate change and options to mitigate such risks.
- Seek opportunities to invest in viable emission reduction projects and focus on customers producing "clean technologies" that reduce GHG emissions.

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CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FOURTH APPELLATE DISTRICT

DIVISION THREE

JAMES LALIBERTE et al., Plaintiffs and Appellants, v. PACIFIC MERCANTILE BANK, Defendant and Respondent.	G036235 (Super. Ct. No. 03CC07092) O P I N I O N

Appeal from orders of the Superior Court of Orange County, David C. Velasquez, Judge. Reversed.

Arias, Ozzello & Gignac, H. Scott Leviant, Mike Arias, Mark A. Ozzello; Newmeyer & Dillion, Shane E. Coons and Thomas F. Newmeyer for Plaintiffs and Appellants.

Sheppard, Mullin, Richter & Hampton, Alan H. Martin, Robert S. Beall, David Huebner and Jeffrey M. Blank for Defendant and Respondent.

*   *   *

Plaintiffs James LaLiberte and Jann and Dennis O'Connor appeal the trial court's orders sustaining demurrers to class allegations without leave to amend. Plaintiffs contend they should have been allowed to further amend their class definition or to conduct further discovery to identify an adequate class representative. Plaintiffs also contend the trial court erred in ruling that rescission is unavailable as a class remedy for violations of the Truth in Lending Act (TILA) (15 U.S.C. § 1601 et seq.)[1] and regulation Z, implementing TILA.

We agree the trial court erred in denying plaintiffs leave to amend the class definition in their third amended complaint, but conclude it correctly denied plaintiffs leave to amend the class action rescission claim in their second amended complaint.

I

FACTUAL AND PROCEDURAL BACKGROUND

In April 2002, plaintiffs applied to defendant Pacific Mercantile Bank (PMB) for refinance loans secured by their principal residences. In connection with the loan, PMB provided plaintiffs with a disclosure statement purporting to include the disclosures required by TILA. The statement, however, failed to disclose closing fees of $450 charged in each of the loans. Plaintiffs allege this omission violated TILA.

Plaintiffs filed suit against PMB on May 22, 2003. The initial complaint included only individual claims. On November 21, 2003, plaintiffs amended their complaint to include class allegations, listing two subclasses of persons who obtained certain PMB loans, and either failed to receive, or received inaccurate, TILA disclosures. One subclass included persons who obtained loans "during the period from May 22, 2002 to the present." The other subclass included persons who obtained loans "during the

[1] All statutory references are to title 15 United States Code, unless otherwise indicated.

period from May 22, 2000 to the present."[2] The trial court sustained demurrers to the first amended complaint, concluding the class allegations failed to allege sufficient common facts to constitute a single class.

Plaintiffs' second amended complaint alleged four subclasses, two including persons who obtained loans after May 22, 2000, and two including persons who obtained loans after May 22, 2002. PMB again demurred, and filed a motion to strike contending, inter alia, the statute of limitations ceased running on class claims not when the complaint was filed on May 22, 2003, but when plaintiffs first included a class claim in their first amended complaint on November 21, 2003. In opposition to the motion to strike, plaintiffs agreed to amend the class definitions to include only persons who obtained loans after November 21, 2002, for subclasses seeking damages, and after November 21, 2000, for subclasses seeking rescission.

The trial court sustained demurrers to the second amended complaint with leave to amend on class claims seeking statutory damages, but denied leave on class claims seeking rescission, concluding rescission was an individual remedy and therefore unavailable in a class action. The court explained that the class allegations in the second amended complaint were too generic, and that "plaintiff needs to identify the specific provisions of defendant's instruction manuals or policies which led to the violations of the TILA plaintiff has alleged."

Plaintiffs' third amended complaint eliminated subclasses, and defined the single class as follows: "'All persons who obtained a closed-end loan from Pacific Mercantile Bank primarily for personal, family or household purposes secured by either real property or the borrower's principal dwelling during the period from November 21, 2002 to the present." The complaint alleges that PMB had provided neither the named

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[2] Presumably, these dates were determined by the initial complaint's filing date and the one-year statute of limitations for seeking statutory damages under TILA (15 U.S.C. § 1640(e)), and the three-year limitation for rescission under TILA (15 U.S.C. § 1635(f)).

plaintiffs nor the class members a disclosure statement reflecting the closing fee charged in connection with their loans. By amending the class definition to include only those persons who obtained loans after November 21, 2002, plaintiffs eliminated PMB's argument that some of the class claimants were time-barred. But PMB lodged a new objection to the amendment, arguing that the class representatives — who obtained their loans in April 2002 — were no longer members of the class.

The trial court granted PMB's demurrer to the class allegations of the third amended complaint without leave to amend on the sole ground that plaintiffs were not members of the class they purported to represent. The court's ruling did not affect plaintiffs' individual claims against PMB. Plaintiffs now appeal the trial court's order denying leave to amend the class claims in the third amended complaint, and its order sustaining demurrers to plaintiffs' class claims seeking rescission.

II

STANDARD OF REVIEW

An order sustaining demurrers to class action allegations "is appealable to the extent that it prevents further proceedings as a class action." (*Wilner v. Sunset Life Ins. Co.* (2000) 78 Cal.App.4th 952, 957, fn. 1.) In reviewing a trial court's order sustaining a demurrer, we exercise our independent judgment on whether a cause of action has been stated as a matter of law. (*Montclair Parkowners Assn. v. City of Montclair* (1999) 76 Cal.App.4th 784, 790.) A trial court's denial of leave to amend, however, is reviewed for abuse of discretion. Plaintiffs bear the burden of proving the trial court abused its discretion and must demonstrate the proposed amendment states a cause of action. (*Goodman v. Kennedy* (1976) 18 Cal.3d 335, 349.)

III

DISCUSSION

A. *The Trial Court Abused Its Discretion in Denying Leave to Amend*

In sustaining demurrers to the third amended complaint without leave to amend, the trial court held: "Because the named Plaintiffs were never a member of the class they purport to represent, they have no standing to sue on its behalf. 'Where the complaint states a cause of action in someone, but not in the plaintiff, a general demurrer for failure to state a cause of action will be sustained.' (*Payne v. United California Bank* (1972) 23 Cal.App.3d 850 [*Payne*].) On the face of the complaint it is undisputed that plaintiffs were never members of the interested class. Thus, plaintiffs do not belong to the class whom they purportedly represent and cannot give themselves standing to sue by purporting to represent a class of which they [were] never a member."

Plaintiffs contend the trial court's reliance on *Payne* was misplaced, and that *La Sala v. American Sav. & Loan Assn.* (1971) 5 Cal.3d 864 (*La Sala*) compels reversal. We agree.

In *La Sala*, the plaintiff borrowers brought a class action against a lender, alleging that the lender's trust deed form included a provision permitting acceleration if the borrower executed a junior encumbrance on the secured property. After the lender offered to waive the provision as to the named plaintiffs, the trial court dismissed the action, determining that the plaintiffs no longer represented the class because they had received full relief. The Supreme Court reversed, concluding that the plaintiffs should have been given the opportunity to add new class representatives by amendment, even though the lender's waiver removed plaintiffs from the class they purported to represent. (*La Sala, supra,* 5 Cal.3d at p. 868.)

La Sala then addressed the lender's arguments regarding alternative grounds for affirming the trial court's order. One of these arguments — virtually identical to PMB's contention — was that the plaintiffs were never members of the class defined in their complaint. The *La Sala* plaintiffs defined the class as those borrowing money from the lender "'during the four years immediately preceding the filing of this action.'" (*La Sala, supra,* 5 Cal.3d at p. 874.) Because the plaintiffs borrowed money six and 11 years before they filed the action, the Supreme Court acknowledged the plaintiffs never qualified as class members. (*Ibid.*) The court nonetheless recognized that the named plaintiffs shared "'a well-defined "community of interest" in the questions of law and fact involved,'" because they were all persons against whom the lender had threatened to enforce its due-on-encumbrance clause. (*Id.* at p. 875.) The court viewed the time restriction in the complaint as arbitrary, and that the community of interest in the litigation's subject matter extended beyond any four-year period and "encompasses all borrowers, including plaintiffs, who have been threatened with acceleration under the due-on-encumbrance clause within the period of the statute of limitation." (*Ibid.*) The court concluded: "In sum, plaintiffs' nonmembership in the class defined by the complaint stems not from the lack of a community of interest between plaintiffs and the class, but from arbitrary and inadvertent limitation of the class. [Fn. omitted.]" (*Ibid.*) Because the plaintiffs could easily cure the pleading defect by amendment, the court held it would be an abuse of discretion to deny leave to amend. (*Id.* at p. 876.)

La Sala's reasoning applies here as well. In their third amended complaint, plaintiffs allege that they obtained their loans in April 2002, and defined the class members as those obtaining loans after November 21, 2002. The complaint, however, alleges PMB failed to disclose closing fees charged to both the named plaintiffs and the class members. Because dates on which they obtained their loans do not in any way affect the community of interest alleged between the named plaintiffs and class members, it is of no significance.

In response to PMB's demurrer to the third amended complaint, plaintiffs asserted they could change the class definition to the following: "'James LaLiberte, and

Dennis and Jann O'Connor, and all persons who obtained a closed-end loan from Pacific Mercantile Bank primarily for personal, family or household purposes secured by either real property or the borrower's principal dwelling during the period from November 21, 2002 to the present.'"[3] PMB decries this proposed amendment as advancing a "novel theory" which would allow someone having nothing in common with other class members to become a class representative by simply adding his or her name to the class definition. True, one may become a class member by adding his or her name to the class. Doing so, however, does not ipso facto make that person an adequate class representative. The named plaintiffs' adequacy as class representatives in the present case derives from the community of interest in the law and facts involved in the case, not merely because they add themselves to the class definition.

The trial court's reliance on *Payne* was misplaced. There, the plaintiffs sued a bank over its agreement with a vacuum cleaner company, Filter Queen, to finance consumers' purchase of vacuum cleaners. The plaintiffs alleged the bank, because of its financing agreement, participated in Filter Queen's fraudulent and unlawful business practices. The complaint alleged the plaintiffs purchased vacuum cleaners between April and June 1968. As plaintiffs discovered, however, the bank had not begun its financing arrangement with Filter Queen until November 1968. Thus, none of the named plaintiffs had a claim against the bank. *Payne* upheld the trial court's dismissal of the action, noting that the plaintiffs did not have standing to sue the bank because they never were members of the class they purported to represent and had failed to timely seek amendment to add a qualified class representative. (*Payne, supra,* 23 Cal.App.3d at pp. 852, 859.)

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[3] Alternatively, plaintiffs asked the trial court to allow them to take discovery to find a suitable class representative. Because we determine the plaintiffs' requested amendment will make them members of the class, we do not consider whether the trial court should have allowed discovery to ascertain other potential class representatives.

The present case is distinguishable from *Payne.* In *Payne,* the plaintiffs' purchase of their vacuum cleaners *before* the bank's involvement with Filter Queen demonstrated they could not pursue even an individual claim against the bank. Thus, regardless of how the class might be redefined, the plaintiffs could never demonstrate a community of interest with the other class members. Unlike *Payne,* the named plaintiffs in the present case have standing to bring individual claims mirroring those of the class members. Per *La Sala,* the fact that the named plaintiffs' claims arose earlier than those of the other class members is legally insignificant. Moreover, unlike the plaintiffs in *Payne,* the named plaintiffs here properly requested amendment in their opposition to the demurrers.

We conclude the trial court abused its discretion in denying plaintiffs leave to amend their third amended complaint. Our decision addresses only the trial court's denial of leave to amend based on its reading of *Payne.* We recognize that PMB raised a number of other issues in its demurrers to the third amended complaint, and we express no opinion on their merit.

B. *Plaintiffs Cannot Assert Class Claims for Rescission*

In ruling on PMB's demurrers to plaintiffs' second amended complaint, the court held: "Plaintiffs are denied leave to amend to seek either rescission or a declaration of entitlement to rescission on the class claims. The court is persuaded by the rationale of the court in *Gibbons v. Interbank Funding Group* (N.D.Cal. 2002) 208 F.R.D. 278, 280-286, that neither form of relief is appropriate in a class action." Plaintiffs contend the trial court erred in denying leave to amend its class action rescission claim. We disagree.

No California state court has addressed the question whether a right to rescind under TILA applies on a class-wide basis, and the issue remains a matter of sharp debate among other courts.[4] The courts denying class wide rescission interpret section 1635 to provide a personal remedy. (See *Gibbons, supra*, 208 F.R.D. at p. 285.) Under that section, a party seeking to rescind must provide the lender with a notice of rescission. The lender then must, within 20 days, terminate its security interest in the debtor's property, and return to the rescinding party "any money or property given as earnest money, downpayment, or otherwise." Upon the lender's compliance, the rescinding party must tender to the lender any money or property received in the transaction.

Accordingly, "TILA contemplates that 'individuals must choose to assert the right to rescind, on an individual basis and within individual time frames, before filing suit.'" (*Gibbons, supra*, 208 F.R.D. at p. 285.) Here, plaintiffs do not assert that any of the class members served a notice of rescission, and it is doubtful that most of the class members would even desire this remedy. Thus, it is unclear whether an existing controversy actually would surface between the lender and class members. "Without any rescission requests, nor subsequent denials by defendants, it is not at all clear that a justiciable controversy exists between the class and defendants." (*Ibid.*; see also *Jefferson, supra*, 161 F.R.D. at p. 69.)

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[4] Cases holding that rescission under TILA may not be pursued as a class action include: *James v. Home Const. Co. of Mobile, Inc.* (5th Cir. 1980) 621 F.2d 727, 730; *Gibbons v. Internbank Funding Group* (N.D.Cal. 2002) 208 F.R.D. 278, 285-286 (*Gibbons*); *Murry v. America's Mortgage Banc* (N.D.Ill. May 5, 2005, No. 03 C 5811) 2005 U.S. Dist. LEXIS 11751, 2005 WL 1323364 *10-11; *Jefferson v. Security Pacific Financial Services, Inc.* (N.D.Ill. 1995) 161 F.R.D. 63, 68-69 (*Jefferson*); *Mayo v. Sears, Roebuck & Co.* (S.D.Ohio 1993) 148 F.R.D. 576, 583. Cases allowing TILA rescission claims to be pursued as a class action include: *McKenna v. First Horizon Home Loan Corp*. (D.Mass., Nov. 10, 2005, Civ. A. No. 04-10370-RCL) 2005 U.S. Dist. LEXIS 41491 (*McKenna*)**;** *Rodrigues v. Members Mortg. Co., Inc*. (D.Mass. 2005) 226 F.R.D. 147, 153; *Latham v. Residential Loan Ctrs. of America, Inc*. (N.D.Ill., May 6, 2004, No. 03 C 7094) 2004 U.S. Dist. LEXIS 7993, 2004 WL 1093315; *McIntosh v. Irwin Union Bank & Trust Co*. (D.Mass. 2003) 215 F.R.D. 26, 33; *Williams v. Empire Funding Corp.* (E.D.Pa. 1998)183 F.R.D. 428, 435-36.

Courts allowing rescission class claims sidestep the notice issue by ruling that "the filing of the complaint constitutes statutory notice of rescission . . . ." (*Taylor v. Domestic Remodeling, Inc.* (5th Cir. 1996) 97 F.3d 96, 100; see also *McIntosh, supra,* 215 F.R.D. at p. 323.) To construe the mere filing of a class action complaint as a statutory notice of rescission, however, would trigger the lender's obligation to terminate its security interest in all of the class members' property, and could trigger the class members' obligation to tender the money or property received back to the lender. Unlike class actions seeking damages or an injunction, rescission under TILA creates obligations between both the lender and the borrower. We agree with those courts that hold rescission under TILA is a personal remedy not suitable for class action treatment.

Moreover, Congress has expressly provided for class actions under section 1640, governing statutory damages, and has never amended section 1635, governing rescission, to include any mention of class actions. In particular, section 1640 was amended in 1974 to cap damages recoverable in a class action. The provision currently provides that "the total recovery . . . in any class action or series of class actions arising out of the same failure to comply by the same creditor shall not be more than the lesser of $500,000 or 1 per centum of the net worth of the creditor[.]" (§ 1640(a)(2)(B).) The purpose of this limitation was "'to protect small business firms from catastrophic judgments.'" (H.R. Conf. Rep. No. 93-1429 (1974), quoted in *Johnson v. West Suburban Bank* (3d Cir. 2000) 225 F.3d 366, 372.) Although Congress initially enacted a $100,000 class action damages cap, it was raised two years later to $500,000, based on the following reasoning: "The recommended $500,000 limit, coupled with the 1% formula, provides, we believe, a workable structure for private enforcement. Small businesses are protected by the 1% measure, while a potential half million dollar recovery ought to act as a significant deterrent to even the largest creditor." (S. Rep. No. 94-590, at 8 (1976), quoted in *Johnson*, at p. 373.)

Plaintiffs assert we cannot infer congressional intent from its failure to include class action provisions in section 1635. They rely on *McKenna*, which noted: "This court does not find it significant that Congress expressly referred to class actions in connection with setting a damages cap, but did not make a comparable amendment to the rescission statute. It is just as likely that Congress did not intend to in any way limit rescission claims which are designed to put the consumer back in the same position as before the inaccurate information was provided." (*McKenna, supra*, 2005 U.S. Dist. LEXIS 41491, *23-24.)

We disagree with *McKenna*, and find it difficult to believe that Congress would carefully balance the deterrent effect of class actions under TILA against the potential harm to businesses in the context of statutory damages, and yet allow class action rescission to proceed without any safeguard for the affected business. As noted above, a lender subject to rescission must, within 20 days of receiving a notice of rescission, terminate its security interest in the debtor's property. (§ 1635.) The lender must do so *before* the debtor must tender to the lender any money or property received in the transaction. (*Ibid*.) PMB's secured loan to the O'Connors alone was $375,919.92. Here, 100 class members seeking rescission would mean PMB could face the loss of over $37 million in security upon entry of an unfavorable declaratory judgment. In other words, a declaratory judgment authorizing all class members to rescind their loans could be "catastrophic."

This situation begs the question why Congress would cap recovery on class actions under section 1640, yet not do so for section 1635. The answer is found in the status of case law in 1974 and 1976, when the cap was enacted and increased. During this time period, numerous cases recognized that class actions seeking damages under section 1640 were appropriate, but class actions seeking rescission were virtually nonexistent. (See *Nelson v. United Credit Plan, Inc.* (E.D.La. 1978) 77 F.R.D. 54.) In *Nelson*, the court made the following observation of the situation as it existed in 1978:

"[We] note that there is not a single precedent in which class certification was broached, must less granted or denied, in a case where rescission pursuant to 15 U.S.C. § 1635 was the relief prayed for. While class actions are not discouraged under the Truth-in-Lending Act any more than in other contexts [fn. omitted] and it appears that Congress intended that some Truth-in-Lending violations would proceed as class actions, [fn. omitted] we have found no evidence of congressional intent that class treatment is appropriate in actions seeking rescission in the Truth-in-Lending context." (*Nelson*, at p. 58.) Footnotes omitted.) Thus, we believe Congress's failure to address class actions in section 1635 when it amended section 1640 did not demonstrate a desire that rescission class actions proceed without limitation, but reflected the fact that no one had sought to use a class action to obtain rescission.

We conclude the trial court did not err in denying plaintiffs leave to amend their class action rescission claim.

IV

DISPOSITION

The order denying plaintiffs leave to amend the class definition in their third amended complaint is reversed. The order sustaining demurrers to plaintiffs' class action rescission claim in the second amended complaint is affirmed. In the interest of justice, each party shall bear its own costs of this appeal.

ARONSON, J.

WE CONCUR:

SILLS, P. J.

RYLAARSDAM, J.